Author:
Roach, Lee

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Corporate governance : the traditional legal model of the company and the extension of its theoretical foundations in support of expanding the scope of current governance protection

Corporate Governance: the Traditional Legal Model of the Company and the Extension of its Theoretical Foundations in Support of Expanding the Scope of Current Governance Protection.

Lee Roach.

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Abstract.

The issue of whose interests should company law/corporate governance seek to protect forms one of the oldest debates in company law academic literature. However, despite the abundance of literature and the recognised importance of the issue, very little practical progress has been made since the debate first ignited in the 1930 s. The result is that corporate governance and company law protection have come to be dominated by the legal model of the company which states that the shareholders should be the sole beneficiaries of company law/corporate governance protection.

Academics wishing to expand the scope of company law protection tend to advance moral arguments for including stakeholders within the scope of company law protection. However, moral arguments are unlikely to convince business leaders and policy makers, who are more concerned with economic and legal considerations. Economic arguments need to be forthcoming, but to date, economic literature has played a limited role in UK corporate governance analysis.

This thesis aims to demonstrate how the UK corporate governance scene has been dominated by the pro-shareholder ideologies of the legal model. It then goes onto highlight the deficiencies of the legal model and to advance economic, legal and theoretical justifications for expanding the scope of company law protection. Paradoxically, this will be done by reference to the arguments traditionally used to justify adherence to the legal model itself.

It will be seen that the traditional arguments that advocate a shareholder-centred view can no longer justify such a position. In fact, they are used in this thesis to justify company law protection for non-shareholder constituents, notably the employees, creditors and the environment.

Dedication and Acknowledgments.

I would like to thank my supervisor Professor John Parkinson of the University of Bristol for his invaluable help and support during the course of this Ph.D. His death earlier this year was a shock to all that knew him. He will be missed as a mentor, a colleague and a friend.

I would also like to thank Dr. Tim Pryce-Brown of the University of Glamorgan and Hywel Wakefield for their assistance and comments relating to several draft chapters.

The law is correct as of 31st March 2003. Subsequent reforms, notably those brought in by the Enterprise Act 2002, are not included.

L.R.R.
March 2004.

Author s Declaration.

I declare that the work in this dissertation was carried out in accordance with the Regulations of the University of Bristol. The work is original except where indicated by special reference in the text and no part of the dissertation has been submitted for any other degree.

Any views expressed in the dissertation are those of the author and in no way represent those of the University of Bristol.

The dissertation has not been presented to any other University for examination either in the United Kingdom or overseas.

SIGNED: [signature] DATE: 16.06.04

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PART IV. REFORM.

Introduction.

The Scope of Corporate Power.

Over seventy years ago, Adolf Berle stated:

> It is the thesis of this essay that all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears. [1]

This approach formed a significant part of what academics have termed the legal model of the company. The legal model of the company is a term that will be used throughout this thesis so it is worth defining it at the outset. The legal model of the company, at its most basic, can be split into two tenets. First, companies should act solely in the interests of their shareholders *i.e.* they should maximise profits. Second, in order to facilitate this end, company law should solely protect the shareholders. Both of these issues will be examined in this thesis but it is the second issue that this thesis concentrates on. This thesis is primarily concerned with what the Company Law Review Steering Group termed the scope of company law, *i.e.* which parties within the corporate nexus should company law seek to protect.

The issue of in whose interests companies should be run is a crucial societal issue. The sheer scope of corporate power means that companies have the power to affect an extremely large number of persons. Since corporate power is largely related to size, this thesis will be concerned principally with the largest of companies, namely large, listed public companies. These companies, both historically and contemporarily, have represented a very small proportion of the total number of firms. At the end of 2002, there were 1,479,100 private companies compared to only 12,400 public companies.[2] Public companies represent 0.8% of the total number of companies in the UK.[3] But while, these companies form only a small percentage of the total number of firms, they dominate the economy to such an extent that a large proportion of economic

[1] A.A. Berle Jr., *Corporate Powers As Powers in Trust* (1930-1) 44 Harv. L. Rev. 1049 at 1049.
[2] DTI, *Companies in 2001-2002*. 2002. London: DTI, p.27.
[3] *Ibid.*

activity in present-day capitalist economies is concentrated in a relatively small number of absolutely large firms. [4]

To gain an impression of the sheer scope of corporate power, consider the following. Of the 100 largest economies in the world, 51 are corporations; only 49 are countries.[5] The combined sales of the world s largest 200 companies amounts to over a quarter of the world s economic activity.[6] These companies have sales larger than the combined economies of all the countries in the world minus the largest nine.[7] Individually, the largest corporations have staggering power and influence. Wal-Mart, the 12th largest corporation in the world, has larger combined sales than 161 countries including Israel, Poland and Greece. Phillip Morris has sales larger than the GNP of New Zealand.[8]

As corporations grow, their geographical influence increases. Corporations are often perceived as having national loyalties, notably to the country in which they are based. For large multinational companies, however, this is no longer the case:

> although we think of IBM and General Motors as American, and Unilever and Shell as British (or, more exactly Anglo-Dutch), firms as large and diverse as these plan their operations on a global scale in their own interests. In terms of sheer size they are sometimes bigger than the countries in which they operate; they are estimated to control over a quarter of world output; and their inter-firm shipments of goods from one country to another account for nearly one-third of recorded trade. [9]

It is apparent that the scope of these firms ensures that they have the ability to drastically affect the lives of much of the world s population. As far back as 1973, the CBI stated that:

> Our style of life is largely determined by the activities and style of business; and the style of business is largely determined by the activities and style of our companies. [10]

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[4] P.J. Devine *et al*, *Introduction to Industrial Economics*, 1985, 4th ed., London: Allen & Unwin, p.86.
[5] *Top 200: The Rise of Global Corporate Power* [Online] Available http://www.corpwatch.org/trac/corner/glob/ips/top200.html 25th September 2000, p.1.
[6] *Ibid.* The actual figure is 28.3% of the world s GDP.
[7] Officially, there are 191 countries. This means that the world s largest 200 corporations have sales larger than the other 182 countries.
[8] R.J. Barnet and J. Cavanagh, *Global Dreams: Imperial Corporations and the New World Order*, 1994, New York: Simon & Schuster, p.45.
[9] P. Donaldson and P. Farquhar, *Understanding the British Economy*, 1988, London: Penguin, p.162.
[10] Confederation of British Industry, *The Responsibilities of the British Public Company*, 1973, London: CBI, p.8.

The effect that corporations have on our everyday lives cannot be overestimated. Accordingly, the aims that corporations are obliged to follow form a fundamentally important societal issue.

An Overview of this Thesis.

It is this issue which this thesis concentrates on. In doing so, this thesis is divided into four parts. Part I examines the theoretical, legal and practical issues behind UK company law and corporate governance. It begins in Chapter 1 with an examination of what has come to be known as the Harvard Debate, the opening quote of which began this thesis. The legal arguments put forward in the debate are no longer contemporary, but the theme of the debate is still of great relevance. It therefore forms a useful introduction to the stakeholder issue.

Chapter 2 examines the oldest justification for the legal model approach, namely the ownership model. The basic thrust of the ownership argument is that the shareholders contribute the capital. They therefore own the company and have a right to have it run in their interests. Already from this simple exposition it can be seen that this argument is not without its flaws. These flaws and other related issues will be examined in detail.

The inaccuracies of the ownership model necessitated a new conceptualisation of the company. This conceptualisation, entitled the new economic theory of the firm, came to prominence in the 1980 s. It was based not on ownership claims, but on contract. The company became a nexus of contracts and therefore incapable of ownership. The new economic theory currently forms the dominant conceptualisation of the company and is examined in Chapter 3.

Chapters 4 and 5 examine the practical and legal realities of the stakeholder debate. Chapter 4 looks at the current law relating to the stakeholder debate. The legal position of the shareholders is examined together with the only two stakeholders that the law has sought to protect, namely the employees and the creditors. As will be seen, the law is very much pro-shareholder and those measures that are supposed to protect the employees and creditors are seen to be unsatisfactory. Chapter 5 looks at the mechanisms of corporate governance that operate in the UK. All of the major mechanisms are examined in depth and two conclusions made. First, it is seen that many of the mechanisms are not effective in increasing levels of corporate stewardship. The second conclusion carries on from the conclusion of Chapter 4, namely that the UK corporate culture is one of shareholder primacy. It is seen that almost all of the various mechanisms are designed to protect the shareholders, give the shareholders a voice or to place pressures upon the directors to act in the interests of shareholders.

Part I of this thesis, especially Chapters 4 and 5, were designed to demonstrate how much the UK corporate scene is influenced by the legal model of the company. This is continued in Part II which begins with an examination of the theoretical, legal and economic justifications behind this legal model.

These justifications are examined in Chapter 6. This chapter begins with an examination of the legal model s preoccupation with profit maximisation. It is Part II of this chapter that this thesis focuses on. Here the three traditional justifications for exclusive shareholder governance protection are examined and form the basis of much that is to follow. This chapter argues that the traditional justifications for adherence to the legal model are no longer sufficient.

This insufficiency is strengthened by the analysis in Chapter 7. Chapter 7 uses the traditional justifications examined in Part II of Chapter 6 to justify expanding the scope of corporate governance protection to non-shareholder constituents, specifically the employees and creditors. It will be seen that adapting the traditional justifications provides a compelling argument for the expansion of our system of corporate governance beyond the narrow confines of the legal model.

Part II of this thesis concludes with Chapter 8 which examines the validity of acts which depart from the legal model of the company. It will be seen that the legal situation is far from clear. If the law is to adopt a wider approach, the law will have to be reformed to reflect this.

Part II aimed to demonstrate that there are benefits to expanding the scope of corporate governance protection to non-shareholder constituents. However, the expansion that was suggested was a modest one, advocating protection for the employees and creditors only. There are other parties that the law seeks to protect and one of the most prominent over the last two decades has been the environment.

Environmental protection is the focus of Part III. Here, the traditional methods of environmental regulation are examined. It will be seen that none of these methods in isolation can effectively regulate corporate environmental activity. This inability is accentuated by the corporation s unique ability to evade or to compensate against the various forms of environmental protection. These abilities will also be examined. Finally, using the traditional justifications for exclusive governance protection that were examined in Chapter 6 and used to justify employee and creditor protection in Chapter 7, several justifications will be offered for expanding the scope of corporate governance protection to include the environment.

This thesis ends with Part IV. This part examines the work of the Company Law Review Steering Group, in particular their recommendations for a statutory statement of directors duties and the proposals for the Operating and Financial Review. Their recommendations have formed the basis for a governmental White Paper, the recommendations of which will also be examined.

Economics and Corporate Governance.

For many years the stakeholder debate has been dominated by moral and theoretical arguments. Persuasive though these arguments are, they are unlikely to convince business leaders and policy makers unless they are accompanied by equally convincing economic justifications. Yet it is only recently that economics has come to play a role in analytical company law literature.

This is surprising given the fundamental importance that economics has for corporations. A company relies on there being a market demand for its products or services. Similarly, those parties within the corporate nexus act in accordance with economic considerations. When shareholders purchase equity in a company, they do so on the basis that they will receive a dividend and that the value of their equity will increase. The company s creditors are equally motivated by economic considerations. When lending money, they will charge an amount above the money loaned, usually in the form of an interest rate. A company s employees will pay close attention to the salary and benefits offered by a company before they decide to become an employee of that company.

Given the pervasiveness of economic considerations, economic analysis can offer significant insights into the motives behind those who take part in corporate activities. In America, economic theory is perhaps the most important and abundant body of literature in relation to corporate law.[11] In the UK, however, economic analysis has played a very limited role in company law analysis to date.

Recognising the importance of economic considerations, this thesis will examine the stakeholder debate not only in a theoretical and legal light, but also taking into account the various economic arguments. This is especially so in Chapters 6 and 7 when the rationales behind the legal model and my proposed rationales are examined.

[11] W.T. Allen, *Contracts and Communities in Corporation Law* (1993) 50 Wash. And Lee L. Rev. 1395 at 1399.

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The Harvard Debate.

Introduction.

In the late eighteenth century, corporations, in both America and Britain, were incorporated principally to serve public/social needs. As one commentator noted:

> [A]lmost all of the business enterprises incorporated here in the formative generation starting in the 1780 s were chartered for activities of some community interest - supplying transport, water, insurance, or banking facilities. [1]

This idea that corporations had a social function was to continue well into the nineteenth century.[2] Despite this, corporations were still viewed by the public with suspicion. In its earliest incarnations, the corporation was equated with monopoly, and monopolies presented great opportunities for abuse.[3] This coupled with the liberalization of general corporation laws and the removal of prohibitions regarding size ensured that the public remained perturbed by a potentially unaccountable concentration of power.

This concern culminated in the events surrounding the Great Depression. During the hearings that grew out of the 1929 market collapse, numerous abuses of corporate power came to light, confirming the fears that the public had long held.

It was out of this period that two academics, Professor Adolf A. Berle and Professor E. Merrick Dodd, engaged in a debate which was, and still is, of tremendous importance and relevance. The issue on debate was posed by the title of Professor Dodd s opening article *For Whom Are Corporate Managers Trustees?* [4] In other words, the issue in question was in whose interests should the corporation be run.

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[1] J. Hurst, *The Legitimacy of the Business Corporation in the Law of the United States 1780-1970*, 1970, Charlottesville: University Press of Virginia, p. 15. He went on:

> Of the 317 separate-enterprise special charters enacted from 1780 to 1801 in the states, nearly two-thirds were for enterprises concerned with transport (inland navigation, turnpikes, toll bridges); another 20 percent were for banks or insurance companies; 10 per cent were for the provision of local public services (mostly water supply); less than 4 per cent were for general business corporations.

[2] *Ibid.* at pp. 161-2.

[3] A.A. Sommer Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later* (1990-91) 16 Delaware J. of Corp. L. 33 at 36.

[4] E.M. Dodd, *For Whom Are Corporate Managers Trustees?* (1932) 45 Harv. L. Rev. 1145.

The Debate.

In the years preceding the publication of *The Modern Corporation and Private Property*, prompted by what he saw as growing problems generated by the growth of the modern corporation, Berle wrote extensively about corporate finance and directors duties. Berle was concerned about the changes that had taken place in the early twentieth century. Corporate power had grown rapidly, so much so that the administration of corporations particularly of the few hundred large corporations that increasingly dominated the economy, had become the crux of American Industrial life. [5] This growth in corporate power and the accompanying rise in oligopololistic and monopolistic firms had, in Berle s view, weakened the market disciplines to which corporate managers were subject. Moreover, this weakening was accompanied by a transformation in the nature of shareholding. By the early 1930 s, as *The Modern Corporation and Private Property* documented, not only had share ownership become ever more dispersed it had taken on an increasingly detached *rentier* form. [6] Berle believed that this, by undermining shareholder supervision and control, had further enhanced the power of corporate management at the expense of accountability. As a result, his work started to concentrate on the growth of corporate power and the ability of managers to utilise that power without constraint. In his early writings, his solution to this problem was forcefully stated in the opening paragraph of his 1931 article *Corporate Powers As Powers in Trust:*

> It is the thesis of this essay that all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears. [7]

It can be seen that Berle s answer to the problems of corporate accountability was a vigorous reassertion of the fiduciary obligation of directors and of the doctrine that held that their powers were held in trust for the shareholders as exclusive corporate beneficiaries, in other words he advocated adherence to the legal model of the firm.

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[5] A.A. Berle Jr., *For Whom Corporate Managers Are Trustees: A Note* (1932) 45 Harv. L. Rev. 1365 at 1365.

[6] P. Ireland, *Back to the Future? Adolf Berle, the Law Commission and Directors Duties* (1999) 20 Co.Law. 203 at 205.

[7] A.A. Berle Jr., *Corporate Powers As Powers in Trust* (1930-1) 44 Harv. L. Rev. 1049 at 1049.

In Berle s view, many of the rules which constrained the director s power and proscribed that they act in the interests of the shareholders were simply outgrowths of equitable rules somewhat analogous to those which apply in favour of a *cestui que trust* to the trustee s exercise of wide powers granted to him in the instrument making him a fiduciary. [8]

One would assume that any critics of Berle s thesis would concentrate on the inaccuracies of this trust analogy and argue that it is inaccurate to analogise directors with trustees. In reality, the only public response to the article advocated the trustee metaphor even more strongly. In an article entitled *For Whom are Corporate Managers Trustees?* Prof. Dodd stated:

> The present writer is thoroughly in sympathy with Mr. Berle s efforts to establish a legal control which was more effectually prevent corporate managers from diverting profit into their own pockets from those of stockholders, and agrees with many of the specific rules which the latter deduces from his trusteeship principle. He nevertheless believes that it is undesirable to give increased emphasis to the view that corporations exist for the sole purpose of making profits for the shareholders. He believes that public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit making function, that this view has already had some effect upon legal theory, and that it is likely to have a greatly increased effect upon the latter in the future. [9]

He pointed out that a number of prominent corporate managers were advocating greater corporate social responsibility. For example, Owen D. Young, then CEO of General Electric, asserted that he was a trustee of the institution and not merely an attorney for the investor. [10] Accordingly, Mr. Young believed that he owed obligations to three groups of people: the shareholders, the employees and the customers and the general public. Dodd believed that this assumption of social responsibility by managers had already manifested itself in areas such as corporate philanthropy.[11] Although he acknowledged that voluntary assumption of such responsibility might not be expected or the norm, the issue was whether acting in the interests of non-shareholder constituents ran counter to the principles of company law.

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[8] *Ibid.*
[9] E.M. Dodd, *For Whom Are Corporate Managers Trustees?* (1931-32) 45 Harv.L.Rev. 1145 at 1147-8.
[10] *Ibid.* at pp. 1158-9.
[11] See *infra.* at Ch. 8.

They did if management acts as trustees only for the shareholders, but Dodd found no clear proof for such a conclusion.[12]

Berle s response was prompt.[13] However, whilst many believe that the views of Berle and Dodd were completely opposed at this time, a deeper examination of their respective positions reveals their aims to be similar. Both men were concerned with reversing the decline in corporate accountability that had arisen in the first part of the twentieth century. Berle advocated a shareholder-exclusive approach, not because he thought their position was more important than other corporate constituents, but because he could see no effective mechanism for enforcing a community standard. As he stated, you could not:

> abandon emphasis on the view that business corporations exist for the sole purpose of making profits for their stockholders until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else. [14]

It is this absence of a mechanism to enforce community demand that was the main difference between the views of Berle and Dodd.[15] In the absence of such a mechanism, it was essential that we had best be protecting the interests we know, being no less swift to provide for the new interests as they successively appear. [16] Accordingly, it can be contended that Berle s view was more pragmatic that Dodd s. [17]

However, pragmatic Berle s view may have been, it was not without its own problems. As several commentators correctly pointed out, the very changes in the nature of corporations and corporate shareholding which had exacerbated the problem of managerial accountability had also served to undermine the shareholder-centred fiduciary mechanisms of control that Berle proposed. One of the principal reasons why corporate managers had grown so powerful was because of the increased decline

[12] E.M. Dodd, *For Whom Are Corporate Managers Trustees?* (1931-32) 45 Harv.L.Rev. 1145 at 1162-3.
[13] A.A. Berle, *For Whom Corporate Managers Are Trustees: A Note* (1932) 45 Harv.L.Rev. 1365.
[14] *Ibid.* at p.1367.
[15] J.L. Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation* (1964) 64 Colum.L.Rev. 1458 at 1462.
[16] A.A. Berle, *For Whom Corporate Managers Are Trustees: A Note* (1932) 45 Harv.L.Rev. 1365 at 1372.
[17] P. Ireland, *Back to the Future? Adolf Berle, the Law Commission and Directors Duties* (1999) 20 Co.Law. 203 at 206.

in active shareholding and the rise of pure *rentier* investment. As one commentator noted, the average shareholder in a large corporation:

> regards himself more as a security holder than as in any sense a responsible managing partner in the enterprise the legal distinction between bondholders and stockholders is fast becoming a distinction unwarranted by the actual situation. [18]

Thus, as Kline observed in a review of one of Berle s books, any movement to increase the power of stockholders [such as Berle was proposing] ran counter to the historical evolution of corporations. [19] There was no doubt that Berle was aware of this, but could simply see no effective mechanism for enforcing a stakeholder viewpoint. He recognised that non-shareholder constituents were worthy of protection, but also recognised that mechanisms that combine stakeholder protection and managerial accountability will take time to develop. Indeed, as we shall see when we examine the mechanisms of corporate governance in Chapter 5, it is still the case that such mechanisms have not been developed.

Although in the Harvard Law Review, Berle s view was clear, elsewhere he does not seem to have espoused such a pro-shareholder approach. In his seminal text *The Modern Corporation and Private Property*, Berle concluded that the American corporation had ceased to be a private business device and had become an institution. [20] Further, relating to the separation of ownership and control, he concluded that the passive shareholders have surrendered the right that the corporation should be operated in their sole interest [21] and that the community is in a position to demand that the modern corporation serve not alone the owners or the control but all society [22] with the managers acting as a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity. [23]

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[18] F.S. Wood, *The Status of Management Stockholders* (1928) 38 Yale LJ. 57 at 59.
[19] J. Kline, *Review of A.A. Berle, Studies in the Law of Corporation Finance* (1929) 45 Harv.L.Rev. 714 at 717.
[20] A.A. Berle & G.C. Means, *The Modern Corporation and Private Property*, 1932, New York: Macmillan, preface at v.
[21] *Ibid.* at p.355.
[22] *Ibid.* at p.356.
[23] *Ibid.*

Maybe this inconsistency was a factor in the final outcome of the debate for in 1954 Professor Berle overcame his misgivings and stated:

> Twenty years ago, the writer had a controversy with the late Professor E, Merrick Dodd, of Harvard Law School, the writer holding that corporate powers were powers in trust for shareholders while Professor Dodd argued that these powers were held in trust for the entire community. The argument has been settled (at least for the time being) squarely in favor of Professor Dodd s contention. [24]

In fact, in a complete reversal of his original position, he stated:

> [M]odern directors are not limited to running business enterprise for maximum profit, but are in fact and recognized in law as administrators of a community system. [25]

What is difficult to see is precisely why Berle conceded the debate to Dodd. Berle s original pro-shareholder approach was entirely pragmatic and his assertion that a mechanism to enforce a community-centred approach would be a long time in coming has been proven correct. As soon as Berle adopted this new position, he was attacked by legal model proponents utilising his own arguments first put forward in the original Harvard debate. Professor Ben W. Lewis, referring to this community-centred approach, stated [i]t is not going to happen; if it did happen it would not work; and if it did work it would still be intolerable for free men. [26] Eugene Rostow considered it to be the rhetoric of mangerialism [27] and finds it disturbing in both its political and legal implications.

Indeed, if one examines the current law, it is evident that a pro-shareholder ideology is still present. The current statement of directors duties is that the directors of a company must act:

> bona fide in what they consider — not what a court may consider — is in the interests of the company, and not for any collateral purpose. [28]

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[24] A.A. Berle, *The 20th Century Capitalist Revolution*, 1954, New York: Harcourt, Brace and Company, p.169.
[25] A.A. Berle, *Foreword* in E.S. Mason (ed.), *The Corporation in Modern Society*, 1959, Cambridge, Massachusetts: Harvard University Press, at xii.
[26] B.W. Lewis, *Economics by Admonition* (1959) 49 Am.Econ.Rev.Supp. 384 at 395.
[27] E.V. Rostow, *To Whom and For What Ends is Corporate Management Responsible?* In E.M. Mason (ed.), *The Corporation in Modern Society*, 1959, Cambridge, Massachusetts: Harvard University Press, p.64.
[28] *Re Smith & Fawcett Ltd.* [1942] Ch. 304 at 306, *per* Lord Greene MR. The *bone fide* duty is examined in more detail in Ch.4.

Although technically, the duty is owed to the entity, a duty to benefit an artificial entity would be irrational, since an artificial entity is incapable of experiencing well being.[29] Accordingly, the interests of the company must be defined in terms of human interests and objectives. Historically, the interests of the company have come to be equated with the interests of the shareholders.[30] Despite provisions such as s.309 Companies Act 1985 and increasing calls for a pluralist approach, reform committees still perceive the company as a vehicle for shareholder enhancement. In 1998, the Committee on Corporate Governance (the Hampel Committee) stated that [t]he single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders investment. [31] Therefore, one could legitimately conclude that although Berle conceded the debate to Dodd, it has been Berle s view that has found greater legal acceptance.

Conclusion.

Despite being over 70 years old, the Harvard Debate remains as relevant as it did when it first began. The question of in whose interests should the company be run is still of tremendous importance. In this respect, the Harvard Debate provides us with a useful introduction. However, the basis of the positions of both Berle and Dodd was premised upon the directors occupying an analogous position to trustees. Today the director s position is totally different to that of trustees. Accordingly, whilst the message of the Harvard Debate remains of great importance, the justifications behind their respective positions are no longer accurate. The conclusion of the debate came with Dodd s view being declared victorious. Yet corporate behaviour has not evolved in line with Dodd s views. If anything, it has been Berle s pro-shareholder view that has become the norm.

Irrespective of whether it is the social service contention of Dodd or the pro-shareholder approach of Berle that is to be justified today, new theories are required to justify them. With the ending of the Harvard Debate, new theories have arisen. The

[29] P.L. Davies and Lord Wedderburn of Charlton, *The Land of Industrial Democracy* [1977] ILJ 197 at 199.
[30] See *Greenhalgh v Arderne Cinemas Ltd.* [1951] Ch. 286.
[31] *The Committee on Corporate Governance*, 1998, London: Gee Publishing Ltd., para.1.16.

trustee analogy waned and legal model proponents adopted a property based model to justify their position. They argued not that directors were trustees, but that the company was owned by the shareholders and so should be run in their interests. It is this ownership model that we examine in the next chapter.

2

Ownership of the Firm

Introduction.

The Harvard Debate brought to the fore an issue which has preoccupied academic corporate literature since. It has split the academic community with some advocating the adoption of a model of the company based around stakeholding principles, whilst others have sought to reinvent the traditional shareholder-orientated, Anglo-American model. However, what both parties agree upon is that shareholders have an important role to play in the governance of the company. Those who advocate the legal model of the company often argue that good governance requires the restoration of shareholder control.[1] Stakeholder theorists argue that the company should not be viewed solely as a profit-maximizing enterprise, but nevertheless should require committed ownership by shareholders, if only to eradicate the danger of short-termism. [2] Accordingly, the Labour government has highlighted the need for more active shareholding and one method of achieving this that has been under consideration for some time is compulsory voting for institutional investors.[3]

Underlying this contention that shareholders need to be more active is the assumption that shareholders own the company. It should be noted that many company lawyers do not assert that the company is owned by the shareholders in the usual sense of the word due to the existence of the company s separate personality. Rather, it is assumed that shareholders have a proprietary interest in the company akin to ownership. Many non-lawyers and economists however, are less hesitant and argue that the shareholders literally own the company. The natural corollary of shareholder ownership is that the interests of shareholders should take priority, if not complete dominance, over the other stakeholders, and that shareholders should have a say in the running of the company.

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[1] See A. Sykes, *Proposals for Internationally Competitive Corporate Governance in Britain and America* (1994) 2 Corporate Governance: An International Review 187 at 194 who states that effective, internationally competitive corporate governance requires the efficient discharge of the ownership role.

[2] W. Hutton, *The State We're In*, 1995, London: Jonathan Cape, p.34.

[3] The governance function exercised by institutional investors will be examined in Ch.5.

Like the new economic theory that was to follow, the ownership model of the company was based on numerous assumptions that even today are taken for granted. However, many of these assumptions, when examined, show themselves to be descriptively inaccurate. For example, despite the general acceptance of the ownership assumption, the legal nature of the share and shareholding is still not clear. As one commentator stated the share does not fit into any normal legal category. [4]

This chapter seeks to examine the ownership model and assess its validity. Like the new economic theory, this will involve analysing a number of satellite issues. For example, many academics argue that the company is owned without establishing what exactly ownership entails. The existence of corporate personality may mean that the company is incapable of being owned. A significant issue that has produced much literature is the relationship between ownership and control. It will be seen that the ownership model as a means of justifying shareholder primacy is no longer convincing and contains many descriptive inaccuracies. It was these inaccuracies that created the theoretical vacuum that provided the opportunity for the new economic theory to flourish.

I. WHAT IS OWNERSHIP?

The ownership model is premised on the contention that the shareholders own the company. As will be seen, this can be doubted for a number of reasons. However, many academics discussing the ownership model ignore a fundamental issue, namely what is meant by ownership. It is an issue that needs to be addressed because when one stated that the shareholders own the company, there is no doubt that the term ownership is being used in a different sense to that which we normally understand.

Many legal theorists when defining ownership look to the classic exposition developed by Honor 40 years ago. [5] Honor correctly noted that our conception of property has varied across time and cultures. Nevertheless, he concluded that there

[4] P.L. Davies, *Gower s Principles of Modern Company Law*, 1997, 6th ed., London: Sweet & Maxwell, p.299.

[5] A.M. Honor , *Ownership* in A.G. Guest (ed.), *Oxford Essays in Jurisprudence*, 1961, Oxford: OUP, p.106.

is indeed a substantial similarity in the position of one who owns an umbrella in England, France, Russia, China. In all these countries, the owner of an umbrella may use it, stop others using it, sell it, or leave it by will. Nowhere may he use it to poke his neighbour in the ribs or knock over his vase. [6] He then went on to explain that there was no simple definition of ownership, rather there are a series of characteristics, and if enough of these characteristics are present, it is logical to describe the relationship as ownership based. Honor lists eleven such characteristics.

There are several obvious ones such as the right of possession, the right of use and the right to manage. There is also a right of income — I can rent my property and keep the revenue. There is a right to capital value — if I sell my property, I can keep the proceeds. There is a right to security from expropriation — if my property is stolen, I can call on the police to apprehend the thief. There is a right to transmission — I can transmit possession by sale, gift or bequest. There is no time limit on these rights. There is, according to Honor , a duty placed upon me not to use my property to do harm. My property can be used to obtain satisfaction of judgment against me — if I do not pay my debts, my property can be seized. Finally, there are some rights to residual control — I can lend my property to others, who then enjoy the rights above, but when the loan ends, all the rights revert back to me.

Before we apply Honor s test to the issue of company ownership, we need to distinguish ownership of the company and ownership of the company s shares. There is little doubt that shareholders own their shares. They have a right of possession — even under CREST shareholders can still insist on holding a physical share certificate. Shareholders obviously have right to the capital value should they sell them. Shareholders may not use their shares harmfully (although it is difficult to see how they could) and creditors may take them if the shareholder does not pay his debts. In relation to the company s shares, shareholders pass ten of Honor s eleven tests. Accordingly, it is settled that shareholders own their shares.

However, this does not mean that shareholders own the company. A shareholder does not have a right of possession of the company. Their right of use is limited to the

[6] *Ibid.* at p. 108.

company s services, so their rights are the same as any other customer s. They do have a right to manage in respect to certain residual powers. However, the vast majority of managerial powers are vested in the directors. Their right to an income is limited to a dividend. Their right to the capital value is only effective in the event of a liquidation, in which case they will be unlikely to get anything. Shareholders do not have rights against the expropriation of company assets.[7] Shareholders cannot sell, gift or bequest company assets as they can their shares. They have no duty to stop the company from acting in a harmful manner and they cannot use company assets to satisfy their debts.

Of Honor s eleven tests of ownership, only two (and these are minor rights) are unequivocally satisfied; three are partly met, and six are not fulfilled at all. If Honor s tests are indicative of ownership, then in fact the directors have a better case for ownership of the company than the shareholders. Directors have rights of possession and management and the ability to dispose of its assets. The duty to stop the company committing harm is placed upon them and they have the right to take action if the company s assets are expropriated. The above findings are set out below.

Table 2.1: Rights of Ownership.[8]

Right	Me over my umbrella	Shareholder over company	Shareholder over shares	Directors over company
Possession	Yes	No	Yes	Yes
Use	Yes	No	Yes	No
Management	Yes	Some	Yes	Yes
Income	Yes	Some	No	No
Capital	Yes	Some	Yes	No
Security	Yes	No	Yes	Some
Transmission	Yes	No	Yes	Yes
No limit of term	Yes	Yes	Yes	No
Duty not to do harm	Yes	No	Yes	Yes
Judgment liability	Yes	No	Yes	No
Residual control	Yes	Yes	Yes	Yes

The obvious conclusion from above is that, if Honor s ownership tests are valid (and it appears to be the most useful definition to date) then no one owns the company.

[7] This was precisely the issue in *Short v Treasury Commissioners* [1948] AC 534, where the shareholders lost.
[8] J. Kay and A. Silberston, *Corporate Governance* in F.M. Padfield (ed.), *Perspectives on Company Law: 2*, 1997, London: Kluwer Law International, p. 55.

Many groups have rights and obligations surrounding the company, but none of them amount to an ownership claim.

The dividing factor in the ownership claims of shareholders is the existence of corporate personality. From the date of incorporation, the company is fully fledged and acquires all the benefits of incorporation, notably separate personality. Persons, natural or juristic, are incapable of being owned, but can exercise ownership rights themselves.[9] Many of the ownership rights that shareholders enjoy over their shares, the company has over itself. As the company is a juridical person, this is perfectly logical.

II. OWNERSHIP OF THE FIRM.

The Evolution of the Ownership Model.

The genesis of the ownership model coincided roughly with the rise of company law as a subject proper. Company law began life in the early nineteenth century as joint stock company law and until the latter half of the century was considered as part of partnership law. Characterized by large numbers of passive shareholders, freely transferable shares and a specialized management — essential features of a modern public company — joint stock companies could in law be incorporated or unincorporated. A joint stock company was a joint stock company irrespective of its legal status.[10] Correspondingly, early joint stock company law texts examined the law relating to both incorporated and unincorporated enterprises.[11]

Another important fact was that for many years, all joint stock companies were considered to be types of partnership. Like many partnerships, joint stock companies tended to be conceptualised as aggregates of individuals. Although incorporation created a separate entity, the resulting body corporate was thought to consist of several individuals, united in such a manner that they and their successors constitute

[9] P.L. Davies, *Gower's Principles of Modern Company Law*, 1997, 6th ed., London: Sweet & Maxwell, p.301.

[10] See C. Wordsworth, *The Law Relating to Railway, Canal, Water, Dock, Gas and Other Companies*, 1851, 6th ed., London: Benning, p. 1 who opens with the statement that joint stock companies are unincorporated and incorporate.

[11] The first company law text is said to be C. Wordsworth, *The Law Relating to Railway, Bank, Insurance, Mining and Other Joint Stock Companies*, 1836, London: Butterworth.

but one person in law, a person distinct from that of any of the members, though made up of them all [12] There was as of yet no conception of the company as something with its own existence. The shareholders were viewed as the company,[13] hence the persistence of the view that the directors were agents of the shareholders, subject to the control of the shareholders in general meeting. This was also reflected in the statutes of the day with many of them stating that people formed themselves into companies, with the implication that companies were formed *of*, rather than *by*, them.

As joint stock companies were viewed as partnerships, so it was that they came to be regulated by partnership law. One of the main texts of the day, *A Treatise on the Law of Partnership, Including Its Application to Joint Stock Companies*, describes company law as a mere statutory development of the law of partnership. [14] In accordance with the law of partnership, ownership of a joint stock company share bestowed on the holder an interest in the assets of the company, with the shareholders being conceptualised as equitable owners of the company s assets. Shareholders were not only the company, but they were also legally constituted as the owners of its assets. However, whilst the shareholders may legally have been the owners, commentators had already started to highlight inaccuracies that would in time render the model anachronistic. As early as 1776, Adam Smith observed that:

> the greater part of these proprietors seldom pretend[ed] to understand any thing of the business of the company; giv[ing] themselves no trouble about it, receiv[ing] contentedly such half yearly or yearly dividend, as the directors think proper to make them. [15]

However, despite academic misgivings, there was a proprietary connection between the shareholders and the assets of the company, and compared to their modern counterparts, eighteenth and early nineteenth century shareholders took a much greater supervisory role within the company. Some companies even financially penalised shareholders who neglected to attend general meetings either in person or by proxy.[16]

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[12] J.W. Smith, *A Compendium of Mercantile Law*, 1843, 3rd ed., London: Maxwell, p. 81.
[13] P. Ireland, *Company Law and the Myth of Shareholder Ownership* (1999) 62 MLR 32 at 39.
[14] N. Lindley, *A Treatise on the Law of Partnership, Including Its Application to Joint Stock Companies*, 1878, 4th ed., London: Maxwell, p.14.
[15] A. Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, 1776, Oxford: Clarendon Press, p. 741.
[16] A.B. DuBois, *The English Business Company After the Bubble Act 1720-1800*, 1938, New York: Octagon, p. 319.

This position altered radically during the mid-nineteenth century. The catalyst for this alteration was the rapid growth in the number and size of joint stock companies. Investment was not only on a hitherto unknown scale, it took a much more passive rentier form. Consequently, after 1830, for the first time there developed a market in joint stock company shares which transformed them into marketable commodities that were highly liquid. The law soon came to recognise this transformation in the nature of the share. In the seminal case of *Bligh v Brent*,[17] it was held that the shareholders had no legal interest in the property owned by the company. All the shareholders had was a right to a dividend and a right to assign their shares for value. It was not long before the shares of both incorporated and unincorporated companies were established as legal objects in their own right, independent of the assets of the company. This left the assets of the company under the ownership of the company alone or, in the case of unincorporated companies, in the hands of the trustees. The shareholders did not own the assets of the company, only the intangible share capital. This created a vital legal space [18] between companies — the owners of assets — and shareholders — the owners of shares.

This separation between the shareholders and the company was accompanied by related changes. For example, Sealy notes that as long as unlimited liability remained general meetings were diligently attended and matters of policy were actively debated [19] and that even after the introduction of limited liability in 1855 shareholders continued to take their role seriously. [20] However, there is no doubt that whilst there was for many years a degree of shareholder supervision, as the century progressed, this supervision steadily declined. Investors who traditionally held shares in one company were starting to diversify their holdings. Shareholders now sought security not through monitoring the company s activities, but from limited liability and a policy of diversification. Soon the shareholders became what one commentator has called blind capital seeking its 5 per cent [21] and any significant supervision ended. Professional managers were salaried to run companies and the

[17] (1837) 2 Y & C Ex 268.
[18] P. Ireland, *Company Law and the Myth of Shareholder Ownership* (1999) 62 MLR 32 at 40.
[19] L. Sealy, *Perception and Policy in Company Law Reform* in D. Feldman and F. Meisel, *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyds, p.25.
[20] *Ibid*.

shareholders finally abandoned their role as owners and adopted the role of functionless rentiers. [22] This was coupled by a move away from the company being viewed as an aggregate of persons. Not only were shareholders established as money capitalists standing outside the company, the company itself, now the sole legal and equitable owner of the firm s capital, was depersonified ceasing to be an association and becoming an institution. [23] Whereas under the 1856 Act companies were formed *of* people, it was clear under the Companies Act 1862 that companies were made *by* them, not *of* them. This was the reification of the company.

This reification of the company and the shareholders expulsion from the position of owner had profound effects of the law relating to joint stock companies, notably the increased recognition of the depersonified nature of the company. This was recognised in the Companies Acts 1844-62 which made corporate personality and limited liability available upon simple registration. The doctrine of *ultra vires*, which developed to protect the integrity of the share as a form of capital,[24] placed the newly reified company beyond even the unanimous will of the shareholders.[25] The directors were increasingly viewed as an autonomous, self-standing organ, rather than as a body subject to the control of the general meeting. This was accompanied by an erosion in the rights of shareholders to intervene in day-to-day management issues. Power was gradually flowing from the general meeting to the board. As the shareholders surrendered their role as owners, so too did they surrender their ownership rights and in doing so surrendered a set of definite rights for a set of indefinite expectations. [26]

The evolution of the ownership model reveals a definite ebb and wake of the model. In the first joint stock companies, there were strong legal and economic reasons to regard the shareholders as owners. However, as joint stock companies proliferated

[21] J.H. Clapham, *An Economic History of Modern Britain, Vol. 1*, 1928, Cambridge: CUP, p.388.
[22] P. Ireland, *Company Law and the Myth of Shareholder Ownership* (1999) 62 MLR 32 at 42.
[23] L. Sealy, *Perception and Policy in Company Law Reform* in D. Feldman and F. Meisel, *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyds, pp.24-6.
[24] See the judgment of Lord Langdale in *Colman v Eastern Counties Railway Co.* (1846) 10 Beav. 1.
[25] *Ashbury Railway Carriage & Iron Co. v Riche* (1874) LR 7 HL 653.
[26] A.A. Berle and G.C. Means, *The Modern Corporation and Private Property*, 1932 (revised ed., 1967), New York: Harcourt Brace, p.244.

and the company became increasingly depersonified,[27] it was apparent that the shareholders no longer occupied the role of owner and instead became simple capital providers. This change was not thrust upon them, but seemed to be an organic evolution that suited both shareholders and the company. The shareholders received a dividend and were able to reduce their risk without having to expend effort in monitoring the company, whilst the directors were free to manage the company without fear of shareholder intervention. This method of management soon came to be viewed as the most efficient.

However, as we shall see, this has not spelt the end of the ownership model. In several ways, modern company law has failed to take certain developments seriously enough and has sought to hang onto certain ownership-based characteristics. This explains why, even today the ownership argument is still advocated, despite its anachronisms. It is to these issues that we now turn.

Company Law and the Nature of Share Ownership.

One significant reason why the ownership model has survived is because the interest conferred upon the shareholders by the share has never been adequately defined. In the absence of an adequate definition, the courts have appeared to fall back on proprietary principles. This part of the chapter considers how a newly emerging subject, company law, struggled to come to terms with the material conditions surrounding its own creation, the most notable condition being the evolving nature of share ownership and the interest conferred therewith.

As we have seen, come the end of the nineteenth century, shareholding no longer entailed ownership of the corporate assets. However, another related development was that due to limited liability, fully paid-up shares and a policy of diversification, share ownership had ceased to be especially risky. All the shareholders wanted was a regular dividend and the managers were happy to provide this. The result was that shares came to be seen as sources of steady income rather than speculative instruments with wildly varying returns. Put simply, shares came to exhibit debt-like

[27] Here depersonified is taken to mean that it was no longer viewed as an aggregate of persons. In another sense, this was accompanied by a strong personification in that the company became a juridical person.

features. [28] This in turn provided more justification for the erosion of the shareholders ownership rights. As shareholders became ever more passive and functionless, remarkable only in [their] capacity to share, without effort or even without appreciable risk, the gains of growth [29] the justifications for their ownership rights became even weaker. Company law as a subject proper was premised upon this separation of the shareholder from the joint stock company. Despite this, company law while stopping short of according shareholders ownership rights over corporations, nevertheless [continued to] vest significant property rights in the shareholders as residual claimants. [30] This is still the case. Company law has abandoned the ownership model yet still retains shareholders at the centre of its governance arrangements.[31] A major reason for this failure to abandon the ownership model is due to the imprecise nature of the share. Knowing the legal nature of the share helps us determine the relationship the shareholder has with the company. Is it one of ownership; is it a principal/agent relationship or is it more akin to a creditor/debtor relationship?

As a leading commentator has stated [t]he court has found it extraordinarily difficult to define the legal nature of shares, despite its familiarity with them. [32] As there is no direct link between the share and the assets of the company the word share is something of a misnomer, for shareholders no longer share any property in common. [33] Usually, the court is content simply to define them as choses in action,[34] which does nothing more than confirm that they are personalty[35], which is self-evident.

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[28] J.B. Baskin, *The Development of Corporate Financial Markets in Britain and the United States, 1600-1914: Overcoming Asymmetric Information* (1988) 62 Business History Review 199 at 232-6.
[29] J.K. Galbraith, *The New Industrial State*, 1967, Harmondworth: Pelican, p.113.
[30] S. Deakin and G. Slinger, *Hostile Takeovers, Corporate Law and the Theory of the Firm* (1997) 24 JLS 124 at 145.
[31] As we shall see in Ch. 5, many, if not all, of the formal governance mechanisms operate to protect the shareholders.
[32] R.R. Pennington, *Pennington s Company Law*, 1995, 7th ed., London: Butterworths, p.69. See also P.L. Davies, *Gower s Principles of Modern Company Law*, 1997, 6th ed., London: Sweet & Maxwell, p.299 who states that the question what is the legal nature of the share is more easily asked than answered.
[33] P.L. Davies, *Gower s Principles of Modern Company Law*, 1997, 6th ed., London: Sweet & Maxwell, p. 300.
[34] *Humble v Mitchell* (1839) 11 Ad. & El. 205; *Colonial Bank v Whinney* (1886) 11 App. Cas. 426.
[35] S.182(1) Companies Act 1985 confirms that shares are personal estate and not realty.

Originally, in the old deed of settlement companies, it was evident that the members shares amounted to equitable rights of property.[36] However, as we have seen, come the early 19th century, it came to be regarded that the shareholders were not owners, in law or in equity, of the company s property.[37] Shares soon came to be viewed in terms of the contractual rights they conferred upon the shareholders. Pennington asserts that today the share is simply the bundle of contractual rights conferred upon the shareholder. [38] He goes on to approve the most widely quoted definition of a share, namely that of Farwell J in Borland s Trustee v Steel Bros. & Co. Ltd.[39] who stated:

> A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with s.16 of the Companies Act 1862 [now s.14 Companies Act 1985]. The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money but is an interest measured by a sum of money and made up of various rights contained in the contract including the right to a sum of money of a more or less amount. [40]

Pennington agues that the definition of the share, given the above statement, is clear. The s.14 contract gives rise to contractual obligations of each member as regards the company and every other member. The aggregate of these rights and obligations of a member is his shareholding and when divided between the shares he holds, they constitute his shares. [41] However, he is also aware that this view is problematic in that the contractual rights afforded by the s.14 contract can be used *against* the company which highlights the shareholder s externality to the company and blurs the distinction between them and debenture holders. Thus it is tempting to deduce that the relationship between [the shareholder] and the company is that of creditor and debtor. [42] However, this assumption is quite wrong. [43] Nevertheless, it is apparent that the contractual rights conferred by share ownership are unusual. At common law, they were transferable at a time when other choses in action were not.[44] This has led

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[36] *Child v Hudson s Bay Co.* (1723) 2 P. Wms. 207; Harrison v Pryse (1740) Barn Ch. 324; *Ashby v Blackwell and Million Bank Co.* (1765) Amb. 503.
[37] *Bligh v Brent* (1837) 2 Y & C Ex. 268.
[38] R.R. Pennington, *Pennington s Company Law*, 1995, 7th ed., London: Butterworths, p.70.
[39] [1901] 1 Ch. 279.
[40] *Ibid.* at p.288.
[41] R.R. Pennington, *Can Shares in Companies Be Defined?* (1989) 10 Co. Law. 140 at 144.
[42] R.R. Pennington, *Pennington s Company Law*, 1995, 7th ed., London: Butterworths, p.170.
[43] *Ibid.*
[44] *Pinkett v Wright* (1842) 2 Hare 120; Poole v Middleton (1861) 29 Beav. 646.

many to conclude that they are property. However, Pennington correctly voices a note of concern. Describing shares as property is innocuous enough providing that we remember that they do not constitute a proprietary interest in the assets of the company. As we noted in the previous section, there is little doubt that shares are indeed property, which means that they are owned by the shareholders. However, they do not confer on the shareholders a proprietary right in the company s assets. Accordingly, when we describe the shareholders as owners, we are defining them as owners of their shares as opposed to owners of the company.

Ownership, Control and Corporate Governance.

We have noted that one reason for the retention of the ownership model is due to the imprecise nature of the share. Another possible reason is that the law has failed to fully embrace the implications of corporate personality. This has occurred because the law has tried to integrate into our company law two mutually exclusive standpoints. The first is the doctrine of corporate personality which reinforces the separate existence of the company at law and, through implication, erodes *de jure* and *de facto* the shareholder s ownership rights.

The second standpoint relates to company law s failure to fully recognise the separation between the company as an entity and the shareholder s status as a rentier investor. Company law still, despite all the evidence to the contrary, categorises shareholders as insiders, members or owners, and continues to grant them residual ownership rights such as the right to vote in general meetings. It has done this:

> notwithstanding the true economic nature of the share; notwithstanding any property nexus between shareholders and the company s assets; notwithstanding the radical externality of shareholders to the company and their superfluousness to and disinterest in the process of production; notwithstanding the fact that there are serious question marks over the legitimacy of their residual control rights, as well as over their desire, competence and practical ability to exercise them; and notwithstanding the fact that company law itself has done so much to demote them from the status of owners. [45]

The above quote is pointing out a simple fact; company law has not taken separate personality to its full conclusion in areas where it is justified to do so, and in many respects still treats the company and the shareholders as synonymous. Consequently,

[45] P. Ireland, *Company Law and the Myth of Shareholder Ownership* (1999) 62 MLR 32 at 48.

and despite the fact that the company has ceased to be a they and has come to be seen as an it, [46] the law insists on treating shareholders, collectively, as [its] only legitimate constituency. [47] This is evidenced when one examines the director s fiduciary duties, such as the duty to act in the best interests of the company with the company meaning the shareholders.[48]

The way many commentators deal with these irreconcilable standpoints is often to ignore them. Very often, it is simply assumed that shareholders are owners of the company, without any examination of the issues involved. One commentator has stated that in this instance ownership operates as a magic solving word [49] or as a transcendental nonsense [50] which academics use to avoid the difficult questions that the ownership model poses. As Parkinson has noted, many academics argue that shareholder s own the firm because they contribute the capital:

> While shareholders are not the owners of the company s assets as a matter of strict law, they are in substance the owners by virtue of being the contributors of the company s capital. [51]

However, new economic theorists correctly argue that the ownership of capital should not be confused with ownership of the firm. [52] Nevertheless, the mistaken analogy [53] of shareholder ownership and the synonomousness of ownership of capital with ownership of the firm continue to cast a long shadow over the governance debate [54] and does much to reinforce the legal model of the company.

This loss of ownership rights without the abandonment of the ownership model has contributed to one of the most important issues in corporate governance, namely the

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[46] L. Sealy, *Perception and Policy in Company Law Reform* in D. Feldman and F. Meisel, *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyds, p.26

[47] *Ibid.*

[48] This duty has been modified by s.309 Companies Act 1985. However, as we shall see in Ch.4, it does little to alter the legal model of the company. The supremacy of shareholder interests is also evidenced in the City Code on Takeovers and Mergers, especially the provisions relating to the directors ability to frustrate takeover bids.

[49] F. Cohen, *Transcendental Nonsense and the Functional Approach* (1935) 35 Colum.L.Rev. 809 at 820.

[50] *Ibid.*

[51] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.34.

[52] E.F. Fama, *Agency Problems and the Theory of the Firm* (1980) 88 Journal of Political Economy 288 at 290.

[53] J. Kay, *The Stakeholder Corporation* in G. Kelly *et al* (eds.), *Stakeholder Capitalism*, 1997, London: Macmillan, p.131.

separation of ownership and control highlighted by Berle and Means in 1932, and it is to this issue that we now turn.

Berle and Means first stated their hypothesis in the seminal text *The Modern Corporation and Private Property* in 1932. The central tenet to their thesis was simple. As little as a century earlier, ownership and control were united with owners of the firm also having a controlling interest. As Chandler put it owners managed and managers owned. [55] Industrialists such as John D. Rockefeller, Cornelius Venderbilt, Andrew Mellon and Andrew Carnegie owned vast numbers of shares in companies they controlled. By the time of Berle and Means, this trend had ended with those in control holding miniscule holdings. Those who controlled the company did not own it, and those who supposedly owned it did not control it — ownership and control had become separated. Today this trend has become even more pronounced. With the exception of individuals such as Bill Gates of Microsoft and the late Sam Walton of Wal-Mart, large companies are run by individuals with stakes that are dwarfed by the holdings of institutional investors. The consequence of this separation is that management can now escape effective shareholder control.

It should be noted early on that there was no conscious choice that ownership and control should become separated. The separation of ownership and control was an unintended consequence of what was then thought as progress, namely the procedural and technological changes that were needed to meet the needs of a rapidly expanding economy.[56] In order for the economy to expand, the market needed to be highly liquid *i.e.* shares had to be easily transferable. This could only happen if shareholders had limited liability and shares were trading at a fairly low rate. Both conditions loosened the bonds between ownership and control. In order to have limited liability, shareholders had to give up control over day-to-day management. In order to keep trading prices low enough to ensure liquidity, shareholders had to allow companies to issue millions of shares, thereby making it almost impossible for any one investor to hold a meaningful stake. Shareholder control was now almost non-existent, with the only real shareholder right being transferability. Shareholders either voted with

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[54] P. Ireland, *Company Law and the Myth of Shareholder Ownership* (1999) 62 MLR 32 at 49.
[55] A.D. Chandler Jnr., *The Visible Hand: The Managerial Revolution in American Business*, 1977, Boston, Mass.: Harvard University Press, p.9.

management or sold their shares. This is the famous trade-off between exit and voice, or as American commentators term it The Wall Street Walk. The point to note is that each improvement in the operation of the stock market made it more difficult for shareholders to exercise their ownership rights. It appears that at the time, no one noticed this erosion until it was too late.

These developments ensured that management could now escape shareholder control and monitoring. There were two reasons for this. First, as noted by Berle and Means, the sheer numbers of shareholders robbed them of any real power. In 1945, the Cohen Committee echoed this view:

> The illusory nature of the control theoretically exercised by the shareholders over directors has been accentuated by the dispersion of capital among an increasing number of small shareholders who pay little attention to their investments so long as satisfactory dividends are forthcoming, who lack sufficient time, money and experience to make full use of their rights as occasion arises and who are, in many cases, too numerous and too widely dispersed to be able to organise themselves. [57]

Further, management had every incentive to increase the number of shareholders.[58] It increases available capital and helps transferability by keeping the prices of individual shares comparatively low.

Second, increasing the number of shares reduces the incentive and ability of the shareholders to gather information. The California Public Employees Retirement System (CalPERS), the largest equity investor in the United States, has invested over $250 millions in General Motors, but, as General Motors is worth well over $30 billions, even this investment seems insignificant. When the number of shareholders is in the hundreds of thousands, or even the millions, and each of those holds shares in a number of companies, no single shareholder can become well informed enough to monitor effectively.

Whilst the separation of ownership and control is now universally accepted, what is not so clear is exactly when the separation occurred. There is little doubt that by 1932 - the year that *The Modern Corporation and Private Property* was published -

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[56] R.A.G. Monks and N. Minow, *Corporate Governance*, 1995, Oxford: Blackwell Publishers, p.100.
[57] *Report of the Company Law Amendment Committee*, 1945, Cmd. 6659, London: HMSO, para. 7(e).

ownership and control had become separated in America. However, there is evidence to indicate that the same separation did not occur in the UK until several decades later.

There was little doubt that the public company was well established by the beginning of the twentieth century. However, the Berle-Means corporation was not yet prevalent due primarily to the persistence of family involvement.[59] In many UK companies floating on the Stock Exchange for the first time, the entrepreneurs who founded them held sizeable blocks of shares and played a major role in the management of these companies. Accordingly, ownership and control were still, in a sense, unified.

This picture of family dominance continued up until the early part of the twentieth century. However, as the decades progressed, family control became less pronounced, but it was still unclear when it had decreased sufficiently for the Berle-Means corporation to dominate.

Academic research carried out at the time suggests that the Berle-Means corporation did not become dominant until the 1950 s. Sargant-Florence examined share ownership patterns in 1936 and 1951 and found a clear move towards dispersed share ownership. He concluded that by 1951 a managerial evolution, if not revolution had taken place and that a separation of ownership and control was clear for very large companies. [60] Hannah lends support to this. He noted that whilst family members had a *de facto* veto over any proposed takeover bid in the 1920 s-30 s, by the 1950 s ownership and control had become sufficiently separated to leave a large number of companies vulnerable to takeover offers.[61]

However, there is evidence indicating that the separation of ownership and control was still not complete even in the 1950 s. Alfred Chandler, an American business

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[58] Although the effects of increasing the number of shareholders have become more limited following the rise of institutional investors.

[59] L. Hannah, *The Rise of the Corporate Economy*, 1976, 2nd ed., London: Methuen, p.24.

[60] P. Sargant Florence, *Ownership, Control and Success of Large Companies: An Analysis of English Industrial Structure and Policy 1936-1951*, 1961, London: Sweet & Maxwell, pp.186-7.

[61] L. Hannah, *Takeover Bids in Britain Before 1950: An Exercise in Business Pre-History* (1974) 16 Bus. Hist. 65 at 67-8.

historian, has argued that until the 1970 s, the nature of industrial capitalism was different in the UK than in America.[62] In America, professionally trained, salaried executives carried out the management of the company through evolving corporate governance systems. Conversely in the UK, there still existed a commitment to personal ways of management and these families played an influential role in the company s management.

Empirical evidence lends support to Chandler s hypothesis. Evidence indicates that core shareholders may have had an important role to play well after Florence s 1951 study. Such evidence convinced some that even as late as 1980 the managerial revolution heralded by Berle and Means in 1932 has probably not yet happened. [63] However, it is probably the case that by the mid-1980 s the separation of ownership and control was complete. Scott examined share ownership patterns in the UK s 200 largest industrial companies and 50 largest financial businesses in the years 1976 and 1988. His data for 1976 indicated that in the companies examined, nearly 50% had a shareholder owning more than 10% of the equity. In 1988, this figure had dropped to just over 30% largely due to the decline of family control.[64]

Ever since *The Modern Corporation and Private Property*, ownership advocates view the separation of ownership and control, and the subsequent erosion of shareholder control, as a problem resolvable only by a restoration of shareholder supervision. However, given the current dispersement of shareholders, not only is this objective undesirable, it is probably impossible. Accordingly, Easterbrook and Fischel criticise proposals to increase shareholder participation[65] and Kay states that all experience suggests [that a restoration of shareholder control is] not very likely to happen, and would not improve the functioning of corporations if it did. [66] The point to be stressed is that the separation of ownership and control is only problematic if the ownership model is valid and it is beneficial for the shareholders to behave like

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[62] A. Chandler, *The Growth of the Transnational Industrial Firm in the United States and the United Kingdom: A Comparative Analysis* (1980) 33 Econ. Hist. Rev. 396 at 396.
[63] A. Francis, *Families, Firms and Finance Capital: The Development of UK Industrial Firms With Particular Reference to Their Ownership and Control* (1980) 14 Sociology 1 at 1.
[64] J. Scott, *Corporate Control and Corporate Rule: Britain in an International Perspective* (1990) 41 Brit. J. Soc. 351 at 362.
[65] F.H. Easterbrook and D.R. Fischel, *Voting in Corporate Law* (1983) 26 J. Law and Econ. 395 at 396.
[66] J. Kay, *The Stakeholder Corporation* in G. Kelly *et al* (eds.), *Stakeholder Capitalism*, 1997, London: Macmillan, p.126.

owners. In the modern corporation, it is highly unlikely that either of these views is correct.

Nevertheless, several commentators argue that there is growing evidence that ownership and control are being reunited through the involvement of institutional investors and the external pressures imposed by the market for corporate control.[67] Whether or not this is true is a matter of debate. However, there is no doubt that they are having an impact, and there is evidence to indicate that it is not a beneficial one. There is now little doubt that over the last two decades Anglo-American corporate conduct has become more focused on rising share prices, and [on making] corporate performance more profitable. [68] If there is a new increase in shareholder activism, it appears to be misplaced and campaigning for the wrong objectives. As several commentators have noted:

> [shareholder] activists, when they have been effective, have been concerned overwhelmingly with financial performance rather than long-term productive investment. [69]

The result is that many commentators, rather than view the rise of institutional investment as a possible source of accountability, now fear its impact, especially when coupled with the market pressures that are now placed on management. The fear is that shareholder power will become too strong and bring about a new tyranny of money and finance [70] with short-term goals being favoured instead of long-term stable policies.

Given this fear, many commentators are advocating a move towards the governance and ownership structures seen in countries such as Germany and Japan. There are two reasons why commentators praise the German model. First, the divorce between ownership and control is much less pronounced in Germany than in Anglo-American systems. Of the two hundred largest German companies, over 90% have a

[67] Both of these mechanisms of corporate governance will be examined in Ch.5.
[68] C. Craypo, *The Impact of Changing Corporate Governance Strategies on Communities, Unions and Workers in the U.S.A.* (1997) 24 JLS 10 at 12.
[69] T. Ghliarducci *et al*, *Labour's Paradoxical Interests and the Evolution of Corporate Governance* (1997) 24 JLS 26 at 29.
[70] P. Ireland, *Company Law and the Myth of Shareholder Ownership* (1999) 62 MLR 32 at 51.

shareholder (usually a bank or another company) with at least 25% of the equity.[71] Second, Germany takes a much different view of the Verbands-pers nlichkeit or corporate personality. There the corporate entity is viewed as an institution with personality, character and aspirations of its own [whose] objectives encompass the interests of a wide-range of stakeholder groups — investors, employees, suppliers, customers and managers. [72] Many have advocated an adoption of this German stakeholding conception of the company.

The view that the corporation is a social organisation is also prevalent in Japan. When Sony began business, its prospectus stated that [w]e shall eliminate any untoward profit-seeking, shall constantly emphasise activities of real substance and shall not seek expansion of size for the sake of size. [73] It is highly unlikely that an Anglo-American company would put a similar sentiment in its prospectus. In Japan, corporate growth is appreciated and sought after primarily for its contribution to utilising the enriching human resources and in creating promotion opportunities workers identify their interests with those of the company which, as a consequence, is regarded as a sort of community. [74]

CONCLUSION.

This chapter has sought to highlight the evolution and current validity of the ownership model. It has been demonstrated that whilst there is little doubt that shareholders own their shares, there is a danger that this will be equated with ownership of the company s assets or even ownership of the company itself. It has been demonstrated that as the company is a juridical person, it is incapable of being owned. Similarly, it is now settled that the assets of the company belong to the separate entity and that the shareholders have no proprietary interest, legal or equitable, in them.

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[71] J. Kay and A. Silberston, *Corporate Governance* in F.M. Padfield (ed.), *Perspectives on Company Law: 2*, 1997, London: Kluwer Law International, p.56.

[72] J. Kay, *The Stakeholder Corporation* in G. Kelly *et al* (eds.), *Stakeholder Capitalism*, 1997, London: Macmillan, p.126.

[73] Quoted in J. Kay and A. Silberston, *Corporate Governance* in F.M. Padfield (ed.), *Perspectives on Company Law: 2*, 1997, London: Kluwer Law International, p.57.

[74] H. Odagiri, *Growth Through Competition: Competition Through Growth*, 1991, Oxford: Clarendon, p.106.

Accordingly, the ownership model as it is currently understood is insufficient to justify the retention of the legal model of the company. It has been for some time. Nevertheless, even today it is still frequently invoked as justification for a pro-shareholder approach. The recent White Paper concerning the new Companies Bill is evidence of this stating that [i]t is crucial to effective corporate governance that the owners of the company hold the directors to account for the company s performance. [75] It is time to jettison the anachronistic notion that shareholders own the company and therefore have a right to have it run in their interests. Shareholders are but one of many inputs and to prioritise their interests ignores the contributions that other stakeholders make.

The inadequacies of the ownership model and its inherent shareholder bias did not sit well with the academic community by the 1970 s. A theoretical vacuum had arisen that needed to be filled. It was filled by the new economic theory of the firm — a conceptualisation of the company based not on ownership, but on contractual principles. It is this theory that forms the current theoretical justification for corporate behaviour and it is this theory that is examined in the next chapter.

[75] *Modernising Company Law*, July 2002, Cm. 5553-I, London: HMSO, para.2.37.

3

The New Economic Theory of the Firm and Residual Risk

Introduction.

Theories of the firm inform and undergird corporate law, but they only intermittently appear as principal points in corporate law discourse. [1] In the previous chapter we noted that for many years the ownership model of the company held prominence and that its influence is still felt today. However, we also noted that its descriptive inaccuracies ensure that it alone cannot provide an adequate justification for prioritising shareholder interests along the lines seen in the legal model of the company. Accordingly, as the ownership model s influence waned, a new model eventually rose to replace it and it is this model that has dominated corporate law literature since.

This new model was the new economic theory of the firm and it advocated a contractual model of the firm rather than a proprietary one. More commonly known as the nexus of contracts, both critics and advocates acknowledged it as a revolution in our understanding of corporate law theory. [2] However, as will be seen, despite the abundance of literature, the new economic theory has not been totally understood.[3] Also, the new economic theory is often viewed through a very narrow perspective without reference to the number of satellite issues that the theory impacts upon.

This chapter will present an analysis of both the theory itself and the satellite issues that surround it such as the relationship with agency costs and residual risk.[4] It will be seen that whilst the theory has shown itself to be a useful heuristic, its worth has been

[1] W.W. Bratton Jnr., *The New Economic Theory of the Firm: Critical Perspectives from History* (1989) 41 Stan.LR. 1471 at 1471.
[2] *E.g.* L.A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel* (1989) 89 Colum.L.Rev. 1449 at 1449.
[3] See *e.g.* W.W. Bratton Jnr., *The Nexus of Contracts Corporation: A Critical Appraisal* (1989) 74 Cornell LR. 407 at 410: [The new economic theory] has not been well understood even though it has been well accepted.
[4] Other issues such as the new economic theory s relationship with state regulation, whilst relevant, are not relevant to the underlying themes of this thesis and so will not be examined.

overvaluated, and that it, like the ownership model, suffers from some serious descriptive inaccuracies.

Origins of the Theory.

Commentators tend to place the origin of the new economic theory around the 1970 s when a number of prominent economists started analysing the firm in terms of the contractual arrangements within it.[5] However, the true genesis of the theory lies back much further.

The nineteenth century business climate was very different from today. Then, very little tension arose between economic practice and corporate economic/legal theory.[6] Economic production tended to be individual rather than collective with sole traders dominating the business scene. Individuals produced goods for sale in the market. Individuals bought goods for consumption in the market. [7] Any collective organization was carried out by the market in the form of price coordination.[8] It was generally assumed that the market would keep the incompetence of business owners in check, and in doing so, it legitimised private economic power.[9]

This individualistic philosophy meant that very few businesses actually used the corporate form. In both the UK and America, the corporation s existence relied on the granting of special charters. In this area, British company law was heavily influenced by developments in America, and therefore an exposition of American corporate history will be useful. In Britain, the corporate form was instituted either by the Royal Charter or via an Act of Parliament. In America, the individual states conferred charters on businesses that received state franchises, *e.g.* public utilities,

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[5] Commentators (*e.g.* W.W. Bratton Jnr., *The Nexus of Contracts Corporation: A Critical Appraisal* (1989) 74 Cornell LR. 407 at 415) trace the origin of this theory to A.A. Alchian and H. Demsetz, *Production, Information Costs and Economic Organization* (1972) 62 Am. Econ. Rev. 777. The phrase nexus of contracts was coined by M.C. Jensen and W.H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure* (1976) 3 J. Fin. Econ. 305 at 310-11.

[6] H. Hovenkamp, *The Classical Corporation in American Legal Thought* (1988) 76 Geo. LJ. 1593 at 1605-12.

[7] W.W. Bratton Jnr., *The New Economic Theory of the Firm: Critical Perspective from History* (1989) 41 Stan. LR. 1471 at 1483.

[8] P. Temin, *The Jacksonian Economy*, 1977, New York: Norton, p. 177.

[9] J.W. Hurst, *The Legitimacy of the Business Corporation in the Law of the United States 1780-1970*, 1970, Charlottesville: University Press of Virginia, p. 82.

transport constructors, banks, insurers and water works.[10] This granting of charters gave credence to the idea that the corporation was a state created reification. Indeed the prevailing corporate legal theory of the time was that the corporation was a legal fiction and an artificial entity;[11] a conception that was stringently upheld by the courts.[12]

This special charter period was a corollary of the concession theory that prevailed in the UK around this time. Likewise, the contractual notion of the corporation was inherited from the UK. During the two centuries prior to the American Revolution, British lawyers had resisted the sovereign s ability to create juridical persons. They contended that only natural persons were entitled to legal status, and to justify this they advanced contractual conceptions of the firm.[13] However, American law, preoccupied with the artificial entity, resisted this line of reasoning, and continued the tradition of individualism.

A transitional period arose however, in the period 1850-80. The harmony between economic practice and legal theory was ended by increased production by incorporated businesses. Individualism started to feel the strain and sole traders started to object to corporate institutions. Manufacturing corporations arose[14] resulting in the corporation becoming the common form for conducting business.[15] State general corporation laws appeared to ensure equal access to the corporate form.[16]

As the number of corporations grew, so did the dissatisfaction with the theory of the firm. The artificial entity ideal was questioned because its roots were based in

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[10] *Ibid.* at pp. 7-8.
[11] P. Vinogradoff, *Juridical Persons* (1924) 24 Colum.L.Rev. 594 at 601; J. Dewey, *The Historic Background of Corporate Legal Personality* (1926) 35 Yale LJ. 655 at 667-78.
[12] See Trustees of Dartmouth College v Woodward 17 US. (4 Wheat) 599 at 662-3 (1980), *per* Chief Justice Marshall: [the] corporation is an artificial being, invisible, intangible, and existing only in contemplation of law.
[13] A.L. Jacobson, *The Private Use of Public Authority: Sovereignty and Associations in the Common Law* (1980) 29 Buffalo L. Rev. 599 at 662-3.
[14] R.C. Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises* (1981) 94 Harv.L.Rev. 561 at 562.
[15] This also meant that the corporation ceased to be associated solely with public interest enterprises. See P. George, *The Emergence of Industrial America*, 1982. Albany: State University of New York Press, p. 82.

concession theory. With access to the corporate form available to almost everybody, it was clear that the corporation was no longer a product of sovereign permission. Similarly, the abundance of sole traders that characterised earlier periods declined as collective corporate manufacturing increased.

This proliferation of corporations paved the way for the meteoric rise of the management corporation [17] commencing around 1890. Prior to this period, individuals carried out single tasks of production. Now they were joined with large corporations performing multiple tasks.[18] Their ability to produce goods quickly and cheaply meant that they were a significant success.[19]

These corporations were dominated by hierarchies of salaried executives. Those who provided capital withdrew from an active participation in management because they believed that they lacked the necessary experience. Ownership and control became practically separated.[20]

Soon management corporations dominated the economy, facilitated by liberal incorporation laws. New Jersey and then Delaware amended their incorporation laws in order to attract corporations to incorporate in their state. The fiduciary safeguards that were present in the mid-nineteenth century suddenly disappeared.[21]

With the rise of the management corporation came a rise in the debate concerning the theory of the firm. From 1930 until around 1980, discussions surrounding the theory of the firm were based on a management-centered conception of large corporate

[16] G.A. Mark, *The Personification of the Business Corporation in American Law* (1987) 54 Uni. Chi. L. Rev. 1441 at 1455.
[17] The term derives from W.W. Bratton Jnr., *The New Economic Theory of the Firm: Critical Perspective from History* (1989) 41 Stan. LR. 1471 at 1486. G.C. Means, *The Corporate Revolution in America*, 1962, pp.51-2 described it as collective capitalism.
[18] A.D. Chandler Jnr., *The Visible Hand: The Managerial Revolution in American Business*, 1977, Cambridge; Mass; London: Harvard University Press, pp.285-6.
[19] Between 1899 and 1929, the population rose 62%. In the same period, industrial production rose 295% and power production rose 331%. See R. Sobel, *The Age of Giant Corporations*, 1984, 2nd ed., London: Greenwood Press, pp.52-3.
[20] This of course was the famous point made by A.A. Berle and G.C. Means, *The Modern Corporation and Private Property*, 1932, New York: Macmillan. For more see *supra*. at Ch.2.
[21] R.C. Clark, *Corporate Law*, 1986, Boston: Little Brown, pp.160-66.

entities. [22] Until the new economic theory appeared, this theory enjoyed widespread acceptance amongst both economists and legal theorists alike.

The managerialist conception has been best described thus:

> The managerialist picture puts corporate management at the strategic center of the large firm. Management, because of its expertise in organizing resources, possesses power and real discretion in its exercise. Management s power has three aspects. First, management groups determine the processes of production and distribution. Second, management groups dominate enormous hierarchical bureaucracies and exercise authority over all of those lower in the hierarchy. Third, management-dominated corporate entities impose externalities on those outside the entities. [23]

However, not everyone viewed the management corporation favourably. An anti-managerialist group appeared denying the accuracy of the managerialist thesis. What is interesting was that they debunked the managerialist picture by advancing a contractual theory of the firm. This theory resurrected the artificial entity conception but rejected concession theory by replacing the sovereign with freely contracting individuals. Paradoxically, however this meant that the theory was hostile to both the management corporation and possible state regulation. Anti-managerialists opted for a lesser evil and advocated certain minimal state-imposed restrictions.[24]

Interestingly, pro-managerialists also drew on contractualism as a means of opposing regulation. Soon, however, contractualism temporarily disappeared as a legitimate legal theory (until it reappeared in the 1970 s), as the debate centered on the issue of whether or not the firm was public or private in nature.

Managerialist corporations continued to grow in both size and number. However, post-war law reviews were critical of corporate theory s pro-managerialist bias. This view eventually eclipsed the managerialist conception.[25] By the 1970 s, anti-

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[22] W.W. Bratton Jnr., *The Nexus of Contracts Corporation: A Critical Appraisal* (1989) 74 Cornell LR. 407 at 413.
[23] *Ibid.*
[24] M.J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory* (1985) 88 W.Va.L.Rev. 173 at 183, 204-5.
[25] G.E. Frug, *The Ideology of Bureaucracy in American Law* (1984) 97 Harv.L.Rev. 1276 at 1311.

managerialists dominated the law reviews.[26] The law, however remained pro-managerialist well into the 1980 s[27] until the new economic theory arose to challenge it. Upon its arrival, new economic theorists made strong claims on its behalf. Michael Jensen, one of the founders of the modern theory, stated the new economic theory would produce a revolution in our knowledge about organizations [during] the next decade or two. [28]

The New Economic Theory of the Firm: A Basic Outline.

The new economic theory was devised in the 1970 s, but did not appear in mainstream corporate legal theory until after 1980.[29] This theory challenged the managerialist conception of the corporation leading to renewed debate over the nature of the firm.

The new economic theory has two variants, the neoclassical variant and the institutional variant. The institutional variant appeared first with an essay by Ronald Coase in 1937.[30] However, despite the importance of this essay, it had little influence until after 1970.[31] The neoclassical variant appeared in 1972[32] and attained considerable popularity in 1976 following Jensen and Meckling s analysis of the firm.[33] As the main themes of the variants are the same, the differences are not

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[26] *E.g.* V. Brudney and M.A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers* (1974) 88 Harv.L.Rev. 297; V. Brudney and M.A. Chirelstein, *A Restatement of Corporate Freezeouts* (1978) 87 Yale LJ. 1354.
[27] *Cf.* the rise of corporate constituency statutes which were adopted to allow managers to combat takeovers.
[28] M.C. Jensen, *Organization, Theory and Methodology* (1983) 58 Acct. Rev. 319 at 324.
[29] *E.g.* F.H. Easterbrook & D.R. Fischel, *Corporate Control Transactions* (1982) 91 Yale LJ. 698; F.H. Easterbrook & D.R. Fischel, *Voting in Corporate Law* (1983) 26 J. of L. & Econ. 395; B.D. Baysinger & H.N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI s Project and the Independent Director* (1984) 52 Geo.Wash.L.Rev. 557; F.H. Easterbrook & D.R. Fischel, *Limited Liability and the Corporation* (1985) 52 Uni.Chi.L.Rev. 89; F.H. Easterbrook & D.R. Fischel, *Close Corporations and Agency Costs* (1986) 38 Stan.L.Rev. 271; L.A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments* (1989) 102 Harv.L.Rev. 1820.
[30] R.H. Coase, *The Nature of the Firm* (1937) 4 Economica 386.
[31] Coase himself stated in 1972 that his 1937 essay was much cited but little used. See R.H. Coase, *Industrial Organization: A Proposal for Research* (1972) 3 Economic Research: Retrospect and Prospect 59 at 62-3.
[32] A.A. Alchian and H. Demsetz, *Production, Information Costs and Economic Organization* (1972) 62 Am. Econ. Rev. 777.
[33] M.C. Jensen and W.H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure* (1976) 3 J. Fin. Econ. 305.

significant for our purposes. Accordingly, only the neoclassical variant will be examined in depth.

The neoclassical variant s central theme is that the firm is a legal fiction that serves as a nexus of a set of contracting relationships among individuals [34] or a marketplace where various constituencies contract for their own protection. [35] Applying this to corporate legal theory, we can see that the managerialist conception is displaced. Firms no longer constitute hierarchies where management determines terms by fiat. As Alchian and Demsetz noted firms have no power of fiat, no authority, no disciplinary action. [They do not differ] in the slightest degree from ordinary market contracting between any two people. [36] Management is thus redefined as a continuous process of negotiation of successive contracts. [37]

The firm as a fictional entity, a prominent feature of the managerialst conception, also largely disappears. Instead the firm becomes merely a device to facilitate contracting between individuals. [38] The firm does not disappear totally as the firm is often a party itself, albeit only as a matter of convenience.

Likewise the issue of who owns the company becomes irrelevant. The firm represents a series of contracts and is therefore incapable of being owned. Equity capital, the traditional legal situs of ownership, devolves into one of many types of inputs [39] As a corollary, the separation of ownership and control is no longer problematic. Once the tenacious notion that a firm is owned by its security holders [40] is removed, there is no reason for shareholders to have any control over the decision-making

[34] *Ibid.* at p.311.
[35] L.L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means* (1988) 22 U.Mich.J. L.Ref. 19 at 23.
[36] A.A. Alchian and H. Demsetz, *Production, Information Costs and Economic Organization* (1972) 62 Am. Econ. Rev. 777 at 777.
[37] W.W. Bratton Jnr., *The New Economic Theory of the Firm: Critical Perspectives from History* (1989) 41 Stan.LR. 1471 at 1478.
[38] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.178.
[39] W.W. Bratton Jnr., *The Nexus of Contracts Corporation: A Critical Appraisal* (1989) 74 Cornell LR. 407 at 420. See also E.F. Fama, *Agency Problems and the Theory of the Firm* (1980) 88 J.Pol.Econ. 288 at 290 who states ownership of capital should not be confused with ownership of the firm. Each factor [of production] in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs
[40] E.F. Fama, *Agency Problems and the Theory of the Firm* (1980) 88 J.Pol.Econ. 288 at 290.

process.[41] It could therefore be argued that the main function of the new economic theory is to establish that large publicly owned companies are efficient notwithstanding the separation of ownership and control that is a usual characteristic of these companies.[42] Some of the above issues will now be examined in more detail.

The Role of Contract in Corporate Law.

According to the new economic theory, the corporation is a creation of contract. It has been contended that this is only a partially accurate description. As one commentator has noted:

> A corporation is a profit-seeking enterprise of persons and assets organized by rules. Most of these rules are determined by the unilateral actions or corporate organs or officials. Some of these rules are determined by market forces. Some are determined by contract or other forms of agreement. Some are determined by law. [43]

This observation is true. Of all the rules that govern companies, contract accounts for a limited amount. Most rules are contained in law. In America, for example, even a small publicly held corporation will be governed by extensive mandatory rules, even in a state such as Delaware.[44] Many states contain provisions similar to those found within the Revised Model Business Corporation Act which contains many more mandatory rules than Delaware. Some states, such as California, impose even more mandatory obligations.[45] A larger public corporation will be subject to even more extensive rules.[46] New economic theorists have attempted to circumvent this criticism by stating that mandatory rules of law are simply off the shelf standard terms that serve to reduce transaction costs. The parties would have adopted them if they were not statutory. The fact that the parties did not actively bargain for them means that

[41] See D.R. Fischel, *The Corporate Governance Movement* (1982) 35 Vand.L.Rev. 1259 at 1276: no reason exists why investors, who provide the firm with capital in anticipation of receiving a certain rate of return generated by the firm s assets, should have any input into the firm s decisionmaking process.
[42] J.E. Parkinson, *The Contractual Theory of the Company and the Protection of Non-Shareholder Interests* in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyds of London Press, p. 122.
[43] M.A. Eisenberg, *The Structure of Corporation Law* (1989) 89 Colum.L.Rev. 1461 at 1461.
[44] *Ibid.* at p. 1483.
[45] For example, all directors must be elected annually (Cal. Corp. Code / 1501 (West 1977)).
[46] Any corporation that has 500 holders of a class of equity securities and more than $5 millions in assets must register under / 12(g) of the Securities Exchange Act. It will then be subject to much more extensive mandatory rules.

they acquire them at no cost.[47] Although this is a logical contention, it is ultimately sophistical.[48] UK statutory rules are mandatory.[49] They are not contractual and to describe them as such highlights the descriptive inaccuracies of the theory. If the new economic theory was valid, and the company was contract then state interference in corporate matters should have died away by now. However, the sovereign presence remains and with it, a vestigial trace of concession theory.

Although the existence of mandatory rules is problematic for the new economic theory s cohesion, they are and should be viewed as beneficial in certain circumstances. The management of a large public corporation has little incentive in adopting constraints on their own managerial freedom. In fact, they may try to insulate themselves from such constraints. Accordingly, the core fiduciary and structural rules that govern divergences of interest between management and the shareholders should not be determined by or be open to variation by management.[50] They should remain mandatory.

Even more problematic than mandatory rules are those rules that are laid down unilaterally. The new economic theory rests upon the assumption of free contracting. If contractual relations are not free, then the theory is severely compromised. This is demonstrated when one examines the contractual position of the shareholders.[51]

Section 14(1) Companies Act 1985 states that:

> Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members

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[47] F.H. Easterbrook and D.R. Fischel, *The Proper Role of a Target s Management in Responding to a Tender Offer* (1981) 94 Harv.L.Rev. 1161 at 1182.
[48] Even Easterbrook & Fischel described the off-the-shelf argument as not entirely satisfactory. See F.H. Easterbrook & D.R. Fischel, *The Corporate Contract* (1989) 89 Colum.L.Rev. 1416 at 1444.
[49] The same is largely true in America, although certain mandatory rules can be opted-out of. See D.R. Fischel, *Labor Markets and Labor Law Compared with Capital Markets and Corporate Law* (1984) 51 U.Chi.L.Rev. 1061 at 1063.
[50] Nor should shareholders be allowed to vary mandatory rules as their consent in varying mandatory rules that favour management may be coerced or tainted by conflict of interest. See M.A. Eisenberg, *The Structure of Corporation Law* (1989) 89 Colum.L.Rev. 1461 at 1474.
[51] The contractual position of other participants within the company will be examined in Ch. 7. The contractual position of the environment will be examined in Ch. 9.

This means that certain provisions in the articles can be enforced by a member in a contract action.[52] If the new economic theory were accurate, then one would assume that the shareholders would bargain with management to obtain as many safeguards as possible when determining what goes into the articles. In reality, this does not occur. In most public corporations, shareholders are so numerous that they neither wish nor are able to play an active managerial role. Accordingly, bargaining between shareholders and management becomes impossible.[53] Article provisions are unilaterally selected by management and the shareholders simply decide whether to invest or not. Investors who buy shares in the market a fortiori buy a package of rights, the contents of which are non-negotiable. [54]

This has important consequences regarding the company s efficiency. Firstly, regarding the public corporation, as the agents (management) are free to act in the knowledge that their principals (shareholders) cannot monitor them, they will have an incentive to work slowly, a problem known as shirking. [55] They also have an interest in diverting their principal s capital for their own use.[56] Secondly, the efficiency justification inherent in the new economic theory rests upon the assumption that all parties freely contract. If the contract (under which the stockholder is said to offer his investment in exchange for managerial services) is knowingly and freely made by the parties its performance makes each of the parties better off and creates a larger pie for society. [57] In other words, free contracting results in optimum governance arrangements and maximum societal wealth creation. Following on from this, if contracting is not free, then efficiency must be compromised. As Brudney notes, the free and bilateral exchange that the new economic theory envisages is absent in the public company.[58]

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52 K.W. Wedderburn, *Shareholders Rights and the Rule in Foss v Harbottle* [1957] CLJ 194 at 209-15.
53 M.A. Eisenberg, *The Structure of Corporation Law* (1989) 89 Colum.L.Rev. 1461 at 1471. See also V. Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract* (1985) 85 Colum.L.Rev. 1403 at 1412 who states that [s]cattered stockholders cannot, and do not, negotiate
54 J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.183.
55 M.A. Eisenberg, *The Structure of Corporation Law* (1989) 89 Colum.L.Rev. 1461 at 1471.
56 *Ibid.*
57 V. Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract* (1985) 85 Colum.L.Rev. 1403 at 1404.
58 *Ibid.* at pp.1404-20.

Finally, there are a growing number of non-contractual, non-governmental rules that are starting to dominate corporate governance matters. In America, most large public corporations are listed on the New York Stock Exchange, which has a virtual monopoly in the liquid trading market for the stock of such corporations. This monopoly allows it to impose a number of obligations. For example, all corporations listed on the Exchange must have at least two outside directors and an audit committee composed of independent directors.[59]

The New Economic Theory, Agency Costs and Residual Risk.

The efficiency justification for the new economic theory is based upon the premise that contracting allows the optimum alignment of managerial and shareholder interests, which in turn minimises agency costs.[60] Accordingly, this element of the theory is based upon the existence of an agency relationship between the shareholders (principals) and the directors (agents).

However, there is good reason to doubt that the shareholder/director relationship is one of agency. The case law and text on the subject define agency as a relationship in which a principal (*P*) appoints agent (*A*), *A* accepts appointment, and both understand that *A s* behaviour is subject to *P s* control and direction.[61] One commentator has described the agency relationship thus:

> [The] paradigm of agency involves an actual, express authority, conferred by the principal upon his agent, their rights and duties often being embodied in a contract. [62]

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[59] New York Stock Exchange Listed Company Manual *ff* 303.00, 312,00 (1983). The Exchange s monopoly has to an extent been weakened by the development of NASDAQ.
[60] It is acknowledged that agency costs can never be totally eradicated. They are an inevitable consequence of the delegation of power to individuals best suited to perform those tasks, but who at the same time have interests that conflict with those whom they are supposed to act in the interests of. See D.R. Fischel, *The Corporate Governance Movement* (1982) 35 Vand.L.Rev. 1259 at 1262-3; E. Fama & M.C. Jensen, *Agency Problems and Residual Claims* (1983) 26 J. of L. & Econ. 327 at 333, 345 and O. Williamson, *Organization Forms, Residual Claimants and Corporate Control* (1983) 26 J. of L. & Econ. 351 at 354-5.
[61] See *e.g.* Dierksen v Albert 106 N.J. Super 220 at 225, 254 A 2.d 809 at 812 (App. Div. 1969); W. Seavey, *Handbook on the Law of Agency*, 1964, St. Paul, Minn.: West Publishing Co., / 3 and H. Reuschlein and W. Gregory, *Handbook on Agency and Partnership*, 1978, St. Paul, Minn.: West Publishing Co.,/ 69.
[62] I. Brown, *The Agents Apparent Authority: Paradigm or Paradox?* (1995) JBL 360 at 360-1.

It is apparent from this that the agency relationship is based upon the principal being able to exert some level of control over his agent.[63] However, as we have seen, the relationship between the directors and the shareholders does not follow this paradigm.

Shareholders do not control or direct the management. In fact, there exist measures that specifically deny the shareholders the power to interfere in management activities. Further, in the classic agency relationship there exist restrictions that prevent the agent from diverting the principal s assets to his own ends. In the law of agency, the starting position is that self-dealing by the agent is categorically prohibited. However, in keeping with this move away from the agency paradigm, corporate law has permitted directors to partake in self-dealing.

The corporate law starting position mimics that of the agency relationship by imposing a fiduciary standard. As far back as 1854, Lord Cranworth LC held that:

> it is a rule of universal application, that no one having [fiduciary] duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect. [64]

However, in the corporate context, this rule is not absolute. Upjohn LJ (as he then was) in *Boulting v Association of Cinematograph, Television and Allied Technicians*[65] explained how this rule could be relaxed:

> The rule is one essentially for the protection of the person to whom the duty is owed. Thus the company is entitled to the undivided loyalty of its directors But the person entitled to the benefit of the rule may relax it . Thus the company may, in its articles of association, permit directors to be interested in contracts with the company. [66]

Accordingly, many companies adopt the provisions contained in Table A which ousts the absolute prohibition and substitutes it with an obligation to disclose the interest to

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[63] A.L. Diamond and P. Verrecchia, *Optimal Managerial Contracts and Equilibrium Security Prices* (1982) 37 J. Fin. 275 at 276-8.

[64] *Aberdeen Railway Co. v Blaikie Bros.* (1854) 1 Macq 461 at 471. See also *Bray v Ford* [1896] AC 44 at 51-2, *per* Lord Herschell: [i]t is an inflexible rule of a court of equity that a person in a fiduciary position is not entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict.

[65] [1963] 2 QB 606.

[66] *Ibid.* at p.636.

the board.[67] The validity of such ouster clauses have been the subject of considerable debate,[68] most notably due to potential incompatibilities with s.310 Companies Act 1985. They have however, been judicially upheld.[69]

This has important consequences for the new economic theory. The efficiency justification of the new economic theory rests upon the premise that it serves to minimize agency costs by efficiently aligning the interests of principal and agent. However, as we have seen, contract, in the shape of arts. 85 and 86 Table A,[70] allows directors to act in their own interests subject to their other fiduciary duties.

A further problem with the new economic theory s efficiency justification is that it focuses solely on the agency costs arising from the shareholder/management relationship.[71] There are other parties within the corporation and a misalignment of interests between these groups and management can also produce agency costs. The question that occupies us is why are these other parties ignored by the new economic theory.

The answer to this question, according to new economic theorists, involves identifying the party best able to bear risk. As corporate performance cannot be predicted with complete accuracy, there must be at least one party that can bear the costs of under-performance. As a trade-off, the party that bears the costs of under-performance will be entitled to the firm s residual income. The shareholders have come to hold this position for the following reason.

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[67] Arts. 85 and 86 Table A in Companies (Tables A to F) Regulations 1985, SI 1985/805 (although art.94 prohibits the director from voting on the transaction in question). This disclosure obligation is reinforced by s.317 Companies Act 1985 which makes it a criminal offence not to disclose to the board an interest in a proposed transaction. However, breach of s.317 does not, it seems, invalidate the transaction (*Hely-Hutchinson v Brayhead Ltd.* [1968] 1 QB 549; *Guinness plc. v Saunders* [1990] 2 AC 663). See also the rules relating to substantial property transactions contained in s.320 Companies Act 1985.

[68] *E.g.* C.D. Baker, *Disclosure of Directors Interests in Contracts* [1975] JBL 181; R. Birds, *The Permissible Scope of Articles Excluding the Duties of Company Directors* (1976) 39 MLR 394; J.E. Parkinson, *The Modification of Directors Duties* [1981] JBL 335; R. Gregory, *The Scope of the Companies Act 1948, Section 205* (1982) 98 LQR 413.

[69] *Tito v Waddell* [1977] Ch. 106 at 248-9, *per* Megarry V-C; *Motivex Ltd. v Bulfield* [1988] BCLC 104 at 116-20, *per* Vinelott J.

[70] It should be remembered that s.14 Companies Act 1985 prescribes that the articles act as a contract between the members and the company.

[71] G. Kelly and J. Parkinson, *The Conceptual Foundations of the Company: A Pluralist Approach* [1998] CfiLR 175 at 178.

Alchian and Demsetz, believed by many to be the pioneers of the new economic theory, characterized the firm as a series of inputs. They also envisaged the occupancy of a central position by a party whose function it would be to monitor the outputs generated by the firm.[72] Monitoring is essential so that those parties providing the inputs do not shirk. Further, this central monitor is given an incentive to monitor by being granted the right to the firm s residual income. If monitoring is effective, the firm becomes more efficient and accordingly, the residual income becomes larger. In the large company, this monitoring function is performed by the board, but ultimately the board itself is monitored by the shareholders.[73] Accordingly, the shareholders are assigned the right to the firm s residual income.[74]

Where there is only one residual claimant, and all the other inputs receive fixed returns, that one residual claimant will act in such a way as to maximize the residual wealth. Ultimately, maximizing residual wealth serves to maximize the total value received by all the other parties and consequently maximizes social wealth.[75] This is why the new economic theory s efficiency justification focuses solely on the shareholder/management relationship.

This is the practical justification behind the new economic theory and like much of the theory, it can be criticised. As we shall see, shareholders may not actually bear that much risk; whatever incentives may exist, shareholders do not monitor effectively and to say that other parties within the firm contract solely for fixed amounts is inaccurate.[76]

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[72] A.A. Alchian and H. Demsetz, *Production, Information Costs and Economic Organization* (1972) 62 Am. Econ. Rev. 777.
[73] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.47.
[74] Linked to this is the idea that other inputs within the firm, most notably the employees, are wealth-constrained and so contract for a fixed return as opposed to an indeterminate return based on corporate performance.
[75] P. Milgrom and J. Roberts, *Economics, Organization and Management*, 1992, London: Prentice Hall International, pp.291-3.

Conclusion.

Many commentators correctly state that the new economic theory of the firm does not provide a definitive conceptualisation of the company. For example, Bratton states:

> Models of the corporation constructed within the new economic theory s limited analytical framework can neither conclusively explain the firm nor adequately serve as blueprints for an improved, reconstituted, fully rationalized future firm. [77]

The new economic theory, as we have seen, contains many descriptive inaccuracies, notably its failure to convincingly incorporate mandatory rules and unilateral rules into its framework. This has led some academics to conclude that the new economic theory s usefulness is coming to an end. As one commentator noted:

> The contractarian movement peaked. Its highwater mark was reached several years ago. Contractarian analysis has been returned to its rightful place as one analytical tool among many in the corporate toolbox. [78]

However, it could be argued that this is selling the new economic theory short. It certainly is true that the model of the firm provided by new economic theory does not provide a definitive explanation of what the company is. However, it is highly unlikely that any model could provide a flawless descriptive analysis of the corporation. What the new economic theory has successfully done is to bring academic company law closer to business practice by focusing on the elements of voluntary exchange that exist in many corporate relationships.

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[76] As we shall see in Ch. 7, other parties who contract for fixed amounts may also face fluctuations in return as a result of fluctuations in corporate performance.

[77] W.W. Bratton Jnr., *The Nexus of Contracts Corporation: A Critical Appraisal* (1989) 74 Cornell LR. 407 at 464.

[78] D.M. Branson, *The Death of Contractarianism and the Vindication of Structure and Authority in Corporate Governance and Corporate Law* in L.E. Mitchell (ed.), *Progressive Corporate Law*, 1995, Boulder, Colorado: Westview Press, p.95 (footnotes omitted.)

4

The Law Relating to Constituents Within the Corporate Nexus

INTRODUCTION

The Harvard Debate examined in Chapter 1 advocated two polarised views. On one hand, Berle argued that companies should act exclusively in the interests of shareholders and the law should therefore only protect shareholder interests, whereas Dodd argued that companies should act in the interests of other stakeholders such as creditors, employees and the community. In advocating his position, Dodd pointed out that it was common practice for companies to engage in corporate philanthropy that did not directly benefit the shareholders. In Chapter 2 we saw that the pro-shareholder approach that our company law has historically adopted was due largely to the ownership model of the company. However, we also saw that the ownership model can no longer be regarded as an accurate conceptualisation of the company or its relationship with its equity holders. Accordingly, the new economic theory analysed in Chapter 3 arose to challenge it and indeed forms the current theoretical foundation behind the modern conceptualisation of the company. The new economic theory did not place the shareholders at the centre of the company, but rather characterised them merely as one of many inputs that enable a company to function. This paved the way for non-shareholder constituents to have their inputs acknowledged in a way that the ownership model failed to do. It may be a coincidence that the rise of the new economic theory in the 1970 s coincided with the first attempts of UK company law to recognise legally the position of non-shareholder constituents.

Irrespective of whether or not the new economic theory had a role to play, the fact is that today the law does recognise that non-shareholder constituents make a valuable contribution to the company. Accordingly over the last two decades, the law has been reformed to include non-shareholder constituents within the protective umbrella of company law. The purpose of this chapter is to examine the various common law and statutory protective measures that have arisen to protect non-shareholder constituents, notably creditors and employees.[1] However, before we can determine whether or not non-shareholder constituents are now afforded equal protection to that of the shareholders, we need to examine what protection the law affords the shareholders. This will be the focus of Part I. Part II will them examine the various cases that have served to create the beginnings of a directors duty to creditors. Statutory provisions such as s.214 Insolvency Act 1986 and the relevant parts of the Company Directors Disqualification Act 1986 which protect creditors will also be examined. Finally, Part III will examine the history behind and the operation of s.309 Companies Act 1985 — a provision which superficially places employees on par with shareholders. Also the developments relating to European Works Councils will be examined.

It will be seen that whilst these developments are welcome in bringing about awareness of the stakeholders contribution, the vast majority of these developments do little to aid the non-shareholder constituents or the protection afforded them. After analysing the various stakeholder provisions and common law principles, one cannot help but feel that the legal model of the company is still dominant, and the interests of stakeholders are inadequately protected.

I. THE *BONA FIDE* DUTY AND THE LEGAL POSITION OF SHAREHOLDERS

The General Statement of Duty.

The general statement concerning the duty of directors when exercising their powers is taken from the judgment of Lord Greene MR in the case of <u>*Re Smith & Fawcett Ltd.*</u>[2] In echoing the words of a former Master of the Rolls,[3] he held that the directors of a company must act:

[1] The protection afforded to the environment will be examined in Ch. 9. The law relating to the company s ability to act in a non-profit maximising manner will be examined in Ch. 8.

[2] <u>[1942] Ch. 304</u>.

[3] Regarding the power conferred by statute upon the *shareholders* to alter the articles of association, Lord Lindley MR in the case of <u>*Allen v Gold Reefs of West Africa Ltd.* [1900] 1 Ch. 656 at 671</u> held that:

> Wide, however, as the language of [s.14 Companies Act 1862] is, the power conferred by it must, like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also *bona fide* for the benefit of the company as a whole.

> bona fide in what they consider - not what a court may consider - is in the interests of the company, and not for any collateral purpose. [4]

It is interesting to compare this case with subsequent cases. In the Canadian case of Teck Corporation Ltd. v Millar,[5] Berger J defined the duty as follows:

> The law says that the directors of a company, in exercising their powers, must act bona fide in what they consider to be the *best* interests of the company [6]

Likewise, in the case of *Lee v Chou Wen Hsien*,[7] Lord Brightman held that a director had to act in what he believed to be the best interests of the company. In Canada, there is a legislative requirement that the directors of companies incorporated under Dominion law must act with a view to the best interests of the corporation. [8]

A duty to act in the *best* interests of the company would seem to require that the directors make the best possible decisions at all times. There is little doubt that such a standard would be impossibly high and almost impossible to police. This has been acknowledged by the courts when in Howard Smith Ltd. v Ampol Petroleum Ltd.,[9] Lord Wilberforce stated [t]here is no appeal on merits from management decisions to courts of law ... [10]

Accordingly, given that directors are not required by law to make optimal decisions, is it in fact true to say that they are not required to *maximize* profits? Profit maximization implies attaining the optimal amount of profit in a given company, yet it has been acknowledged that a duty requiring optimal decision-making is too onerous. Therefore, if the company is to be defined as the shareholders alone and their sole interest is profit, then the duty imposed is not one of profit maximization. However, if the duty is not profit-maximization, it is difficult to see what it is. It cannot be one of profit attainment because a company may make low or indeed no

[4] *Re Smith & Fawcett Ltd.* [1942] Ch. 304 at 306.
[5] (1972) 33 DLR (3d) 288.
[6] *Ibid.* at p.290 (italics added).
[7] [1984] 1 WLR 1202.
[8] S.117(1) Canada Business Corporations Act.
[9] [1974] AC 821.
[10] *Ibid.* at p.832. See also *Richard Brady Franks Ltd. v Price* (1937) 58 CLR 112 at 136 where Latham CJ held that [i]t is not for a court to determine whether or not the action of the directors was wise.

profits for legitimate reasons,[11] and it would be inequitable to deem such instances a breach of duty.

Definitions of this duty have been problematic due to the uncertain nature of some of the phrases contained within it. Most notably, there has been conjecture over the meaning of *bona fide* and the company. Accordingly, both phrases will be examined.

Defining *Bona Fide.*

As has been observed, the expression *bona fide* has two meanings: in good faith and genuine. [12] The distinction is an important one as the former has a subjective connotation whereas the latter is more objective. The main issue therefore, is whether the *bona fide* duty is subjective or objective in nature.

The directors must act bona fide in what they consider - *not what a court may consider* - is in the interests of the company [13] Semantically, it is therefore clear that the duty is subjective in nature and, despite the occasional anomaly,[14] this is how the courts have interpreted it. As Lord Wilberforce stated:

> [t]here is no appeal on merits from management decisions to courts of law: nor will the courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at. [15]

There is certainly some merit in the argument that decisions by directors be scrutinized by an organ distinct from management. However, that function should be reserved for an actual supervisory board as opposed to the court acting as one. Fortunately, the court has recognized this in implicitly adopting the business judgment rule.[16]

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[11] *E.g.* companies that engage in large-scale R & D may sacrifice short-term profit for long-term stability.

[12] L.S. Sealy, *Bona Fides and Proper Purposes in Corporate Decisions* (1989-90) 15 Mon. L.R. 265 at 269.

[13] *Re Smith & Fawcett Ltd.* [1942] Ch. 304 at 306, *per* Lord Greene MR. (Italics added).

[14] *E.g. Dafen Tinplate Co. Ltd. v Llanelly Steel Co. Ltd.* [1920] 2 Ch. 124.

[15] *Howard Smith Ltd. v Ampol Petroleum Ltd.* [1974] AC 821 at 832.

[16] The UK courts have yet to acknowledge the existence of the business judgment rule in that name. However, in *Shuttleworth v Cox Brothers & Co. (Maidenhead) Ltd.* [1927] 2 KB 9 at 23, Scrutton LJ

However, even though the duty is subjective and the court reluctant to interfere, there has always been a bottom line; an objective minimum below which the courts will intervene and strike down a decision irrespective of the *bona fides* of the act. This minimum threshold has become known in company law folklore as the amiable lunatics test, and is derived from the case of Hutton v West Cork Rly. Co.[17] In a decision that embraces both directors and shareholders decisions, Bowen LJ said:

> *[b]ona fides* cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly *bona fide* yet perfectly irrational. [18]

However, this minimum threshold is not particularly high, so in the vast majority of cases, the directors conduct will have to be determined by reference to their subjective motives. As the duty is subjective, the motives of the directors are paramount in judging the validity of an act. Unfortunately in practice, determining these motives will be very difficult and almost certainly beyond the abilities of the court. Accordingly, directors actions will only be in breach of duty if there is overt evidence that the directors have not acted in the interests of the company. For example, in the American case of Dodge v Ford Motor Co.,[19] the directors mistake was to admit that their policy of withholding profits was intended to benefit the employees. They could have easily justified the policy on the grounds of enhancing long-term shareholder profitability.[20] Corporate philanthropy — an act that superficially does not benefit the shareholders — could be justified on the basis that it increases goodwill which in turn can increase long-term profitability. Any policy aimed at corporate expansion, which can be motivated by factors such as an increase in managerial prestige, will appear on the surface to be motivated purely by profit maximisation. Other acts may be integral to the internal workings of the company and so will not be susceptible to attack. Accordingly, the effectiveness of the duty as a means of protecting shareholders is emasculated due to the evidential difficulties of establishing that the directors did not act *bona fide.*

held that [i]t is not the business of the court to manage the affairs of the company. That is for the shareholders and directors.

[17] (1883) 23 Ch.D. 654.

[18] *Ibid.* at p.671.

[19] 204 Mich. 459; 170 NW 668 (1919).

[20] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.94. See also *Re W & M Roith Ltd.* [1967] 1 WLR 432.

Defining the Company.

The definition of this phrase is exceptionally important and may genuinely be said to lie at the heart of a director s duties. Identifying the company serves to identify whom the directors are legally obliged to act in the interests of. It is worth mentioning at the outset that traditionally the company has come to mean the shareholders. This has far reaching consequences in terms of how the company is run, namely that the company has come to be run in the interests of the shareholders. Accordingly, it is an area where judicial interpretation can have important practical consequences. However, as we shall see, the legal authority regarding the shareholders as the company is not particularly strong. In fact, it is highly unsatisfactory.

As was noted earlier, the *bona fide* duty echoes the duty upon shareholders when altering the articles in that the shareholders must act bona fide for the benefit of the company as a whole. [21] Therefore, when defining the company, cases concerning the alteration of articles have been used to provide guidance.

In *Brown v British Abrasive Wheel Co.*,[22] it was stated that *prima facie* the company as a whole might mean two things: it could mean the company as an independent entity, [23] an institution [24] or a commercial entity, distinct from the corporators ; [25] or it might mean all the corporators both the majority and the minority. [26] Following the landmark decision three years earlier of *Salomon v Salomon & Co. Ltd.*,[27] the most natural definition is the former interpretation, namely that the company should mean the corporate entity,[28] and it is apparent that this is what Lindley MR meant.[29]

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[21] *Allen v Gold Reefs of West Africa Ltd.* [1900] 1 Ch. 656 at 671, *per* Lindley MR.
[22] [1919] 1 Ch. 290.
[23] *Ibid.* at p.293, *per* counsel for the defendants.
[24] *British Equitable Assurance Company Ltd. v Baily* [1906] AC 35 at 39, *per* Lord Robertson.
[25] *Greenhalgh v Arderne Cinemas Ltd.* [1951] 1 Ch. 286 at 291, *per* Evershed MR.
[26] *Brown v British Abrasive Wheel Co.* [1919] 1 Ch. 290 at 293, *per* counsel for the plaintiff.
[27] [1897] AC 22.
[28] L.S. Sealy, *Bona Fides and Proper Purposes in Corporate Decisions* (1989-90) 15 Mon. L.R. 265 at 270.
[29] F.G. Rixon, *Competing Interests and Conflicting Principles: An Examination of the Power of Alteration of Articles of Association* (1986) 49 MLR 446 at 449-50.

For a while, the view that the company was the corporate entity prevailed.[30] However, there came a transition in the case of Peters American Delicacy Co. Ltd. v Heath.[31] Here Dixon J held that the company as a whole is a corporate entity consisting of all the shareholders.[32] Whilst this formulation is also nebulous, the words consisting of all the shareholders implies that the company is not simply the corporate entity.

This view was confirmed in the case of Greenhalgh v Arderne Cinemas Ltd.,[33] where Evershed MR held that:

> the phrase the company as a whole does not mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body. That is to say, the case may be taken of an individual hypothetical member and it may be asked whether what is proposed is, in the honest opinion of those who voted in its favour, for that person s benefit.[34]

Accordingly, the company can be taken to mean an aggregate of hypothetical members. In reality, the interests of a hypothetical member will be relatively easy to define, namely they will act and will desire the directors to act in a way that will ensure them a dividend. Therefore, case law has in effect stated that the directors must act *bona fide* in the interests of the shareholders.

However, whilst there is no doubt that this is true, it could be argued that to apply this line of authority to directors duties is inappropriate. The duty when altering articles is placed upon the *shareholders*. When shareholders vote for an alteration of the articles, it is perfectly legitimate for them to act in their own interests, as they are the company as a whole.[35] Share ownership is still viewed as a property right and voting selfishly is merely exercising this proprietary right. In fact, this principle is so strong that any director holding shares may shed his fiduciary duties and vote *qua* shareholder.[36]

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[30] *Sidebottom v Kershaw, Leese & Co.* [1920] 1 Ch. 154; *Dafen Tinplate Co. v Llanelly Steel Co.* [1920] 2 Ch. 124; *Shuttleworth v Cox Bros. & Co. (Maidenhead)* [1927] 2 KB 9.
[31] (1938-39) 61 CLR 457.
[32] *Ibid.* at p.512.
[33] [1951] 1 Ch. 286.
[34] *Ibid.* at p.291.
[35] Given that shareholders may act in their own interests, the question arises whether or not it is appropriate to describe it as a duty.
[36] *Mills v Mills* (1938) 60 CLR 150.

Conversely, directors *per se* are not generally permitted to vote in their own interests.[37] The fiduciary principle was conceived so as to curtail principals adopting self-interested goals. In the case of company law, fiduciary duties were designed to minimize agency costs by ensuring that directors act in the interests of those whose property they invest.

The second authority advanced for the contention that the company refers to the shareholders is a peculiar one and concerns a 1953 takeover bid of Savoy Hotel Ltd. A brief reappraisal of the main events will be of aid.[38]

In 1953, an unknown buyer started purchasing shares in the Savoy Hotel company for the suspected purpose of redeveloping the Berkeley, a prestigious hotel in the Piccadilly area. However, the current directors of the board did not desire to lose control of the Berkeley and so started considering how best to defend their position. Finally, they devised what became known as the Worcester Scheme. The precise content of the scheme will not be discussed here, but generally the object of the scheme was to remove the Berkeley from the control of the speculators. By this time, the speculator revealed himself as Mr. Harold Samuel, a well-known property dealer. He tried to allay the directors fears but failed and they put the Worcester Scheme into action. Samuel responded by requesting the Board of Trade to appoint an inspector to report on the legal position of the Worcester Scheme.[39] Accordingly, Mr. E. Milner Holland QC. was appointed and he reported his findings in 1954.[40]

On the findings of fact, it was apparent that the directors were acting in good faith and genuinely believed that their actions were in the best interests of the stockholders. Accordingly, the Worcester Scheme was *intra vires* and there was no *mala fides*. It therefore, appeared that there were no legal grounds upon which to impeach the scheme.

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[37] There are exceptions to this principle, most notably where a director has disclosed his interest. See s.317 Companies Act 1985 and art.85 Table A, Companies (Tables A to F) Regulations 1985 (SI 1985/805).

[38] For full details, see L.C.B. Gower, *Corporate Control: the Battle for the Berkeley* (1954-55) 68 Harv. L. Rev. 1176.

[39] Such a power was available under ss.164-5 Companies Act 1948.

However, this was not the view of Mr. Holland. He concluded that it was not sufficient that the powers were exercised *bona fide*; it was also relevant to look at the purpose of the exercise of those powers. Here, the directors powers had been exercised in order to render irrevocable for all time the policy view of the present board, so that never thereafter could the stockholders alter the decision of their present Board as to the present or future use of the property of the company. [41] Prior to the Worcester Scheme, the shareholders enjoyed rights over the company s property and the future use of that property. After the Worcester Scheme, they lost, without compensation, the latter right. Mr. Holland stated that as the duties of the directors were owed to the shareholders, their impropriety was obvious.

However, as Mr. Holland freely admitted, his opinion as expressed in the report could have no authoritative force if the matter came to be reviewed by a Court of Law. [42] It is therefore curious that so many academics cite this report as authority for the proposition that the company refers to the shareholders. [43]

Accordingly, one of the most important and pervasive principles in company law has no acceptable legal authority. The question that is still unanswered is why have the courts never overtly stated that the company refers solely to the shareholders. Nevertheless, despite the unsatisfactory legal authority it is widely accepted that, until recently the company referred exclusively to the shareholders. As we shall see, creditors are now part of the company, when the company is insolvent or of doubtful solvency. However, while a company is solvent, the interests of the company are the interests of the shareholders. This is the starting point concerning the current law. One can therefore see that, based upon the construction of the directors duties, our company law in predominantly concerned with offering legal protection to shareholders. However, the protection offered by the *bona fide* duty must be regarded as weak because any tenuous link with profit maximisation will be enough to protect a proposed act from attack.

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[40] *The Savoy Hotel Limited and the Berkeley Hotel Company Limited: Investigation Under Section 165 (b) of the Companies Act 1948: Report of Mr. E. Milner Holland QC.*, 1954, London: HMSO.
[41] *Ibid.* at para.17.
[42] *Ibid.* at para.15.

This placing of the shareholders at the centre of the corporate nexus is an approach embodied by the Company Law Review Steering Group in their statutory draft statement of directors duties. Under this statement, the directors would be obliged to promote the success of the company for the benefit of its members as a whole. [44] However, this statement has a number of qualifications and that need to be acknowledged.

Firstly, this duty is subordinated to the duty to act in accordance with the company s constitution.[45] This is to ensure that where company s had philanthropic objects, the directors would not be in breach of their duties if they subordinated the selfish desires of their shareholders to achieving the company s objectives.[46] Accordingly, the duty to act in the interests of members can be subordinated if the discretion to act in the interests of non-shareholder constituents is intrinsic to the company s objects.

Secondly, there is a belief that the legal model of the company imposes pressures upon directors that force them to neglect the long-term health of the company.[47] Directors should take a balanced view of both long and short-term considerations. Accordingly, the draft statement of directors duties states that directors should take into account the likely consequences (short and long term) of the actions open to the director. [48]

Finally, the draft statement contains a list of other factors that directors should bear in mind. Central to this is the reference to the supply chain.[49] Directors should bear in mind the company s need to foster its business relationships, including those with its employees and suppliers and the customers for its products and services. [50]

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[43] *E.g.* J.H. Farrar & B.M. Hannigan, *Farrar s Company Law*, 1998, 4[th] ed., London: Butterworths, p.381.

[44] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, June 2001, London: DTI, p.345 at Schedule 2(2)(a).

[45] Schedule 2(1)(a) Draft Statement of Directors Duties.

[46] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, November 200, London: DTI, para.3.17.

[47] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, March 2000, London: DTI, para.3.54.

[48] Schedule 2((2)(1)(a) Draft Statement of Directors Duties.

[49] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, November 200, London: DTI, para.3.23.

The reason why the Company Law Review Steering Group recommended keeping the shareholders as the central group within the corporate nexus was that they believed that there was no way of effectively bringing about accountability to a wide range of corporate constituents.[51] It will also be remembered that this was Berle s main objection to Dodd s position as noted in Chapter 1. Accordingly, the Steering Group rejected the adoption of a pluralist approach. However, it can be seen that whilst the draft statement places the shareholders at the centre of the corporate nexus, it also requires directors to take into account wider issues. It is hoped that by taking this approach, it will be easier for the directors to balance the various competing interests.

A Direct Fiduciary Duty.

It is a parochial tenet of company law that directors duties are owed to the company alone and not to the shareholders. *Percival v Wright*[52] is often cited as support for this principle. Here, the plaintiffs offered to sell their shares to the defendants, the chairman of the board and two other directors, at the price of £12.50 per share. After the sale, the plaintiffs discovered that the defendants had negotiated with an outsider for the sale of the entire undertaking, at a price well over £12.50 per share. The plaintiffs argued that the directors owed their fiduciary duties to the shareholders and as such they could avoid the original sale on the grounds of non-disclosure. The court disagreed stating that there was no fiduciary relationship between the directors and the shareholders: the directors owed their duties to the company alone.

However, there is now evidence that this principle is under a considerable degree of strain. [53] A series of cases dating from as far back as 1914 have criticized this principle and have in certain cases provided *ad hoc* exceptions. Accordingly, in certain cases, the directors may owe fiduciary duties directly to shareholders.

The first challenge to *Percival* came in the case of *Allen v Hyatt*.[54] Here, the appellants were negotiating an amalgamation with another company, induced the

[50] Schedule 2(2)(2)(a) Draft Statement of Directors Duties.
[51] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, November 200, London: DTI, para.3.5.
[52] [1902] 2 Ch. 421.
[53] D.D. Prentice, *Creditor s Interests and Director s Duties* (1990) 10 O.J.L.S. 265 at 273.
[54] (1914) 30 TLR 444.

respondents, who were shareholders of the company, to grant them options to purchase their shares at par value so as to facilitate the amalgamation. However, the price the directors paid was lower than the price they had agreed with the purchaser, and they made a considerable profit. The Privy Council affirmed the view of the Ontario courts in holding that the directors must account for the profits to the shareholders. The court acknowledged that in most circumstances the fiduciary duties of the directors were owed to the company. In this case, however, the directors were agents for the shareholders and accordingly, owed their duties directly to the shareholders.

In *Coleman v Myers*,[55] the New Zealand Court of Appeal went one step further and concluded that *Percival* was wrongly decided. In England also, the *Percival* principle has not escaped intact. The first erosion came in the case of *Heron International Ltd. v Lord Grade*.[56] Here, Associated Communications Corporation plc. (AAC) was the subject of a takeover bid by two companies known as Bell and Heron. Article 29(A) of AAC s articles provided that any transfer of voting stock could only be made to a person nominated by the directors. Commenting upon the duty on directors when utilizing article 29(A), Lawton LJ held:

> This duty to determine which person shall acquire and be registered as the holder of voting shares in ACC is a fiduciary power which the directors must exercise in the interests of the company and in the interests of the shareholders of the company. [57]

Accordingly, it is now relatively well established, both in the UK[58] and in America,[59] that in the event of a takeover, the directors owe some of their duties to the shareholders.

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[55] [1977] 2 NZLR 225.
[56] [1983] BCLC 244.
[57] *Ibid.* at p.264.
[58] *Re a Company* [1986] BCLC 383; *Dawson International plc v Coats Patons plc* (1988) 4 BCC 305.
[59] *Unocal Corp. v Mesa Petroleum Co.* 493 A 2d. 946 (Del. 1985); *Revlon inc. v MacAndrews & Forbes Holdings inc.* 506 A 2d. 173, 181 (Del. 1986). However, a highly worrying precedent was set in the case of *Paramount v Time* 571 A 2d. 1140 (Del. Supp. 1991). This case concerned a stock-for-stock merger between Time inc. and Warner Communications in which the shareholders of Time would have the opportunity to vote whether or not to exchange their shares for documents worth about $125 per share. Paramount then entered the fray with a bid of $175 per share, which they later raised to $200 (it is still widely believed that the bid would have been raised to $225). In light of this generous offer, the directors of Time and Warner were concerned that the shareholders would not approve their merger and revised the transaction so that it no longer required shareholder approval. The revised plan meant that the new company would begin life with an estimated debt of at least $7 billions. When the case reached the Delaware Supreme Court, the court concluded that as the merger had been planned for two years, it was proper that it should be permitted to continue, irrespective of the more lucrative alternative.

The most overt judicial statement to date concerning the limitations of Percival came in the case of Re Chez Nico (Restaurants) Ltd.[60] The facts are not directly relevant to the issue of to whom directors owe their fiduciary duties. The leading judgment was delivered by Browne-Wilkinson V-C who stated:

> Like the Court of Appeal in New Zealand, I consider the law to be that in general directors do not owe fiduciary duties to shareholders but owe them to the company: however, in certain special circumstances fiduciary duties can arise which place directors in a fiduciary capacity vis- -vis the shareholders. [61]

He also stated during the course of his judgment that Percival was very doubtful authority [62] for the proposition that directors owe their fiduciary duties to the company. Having said this, however, even though the principle in Percival has been

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This case is extremely worrying for the following reason. The directors contended that they opposed Paramount s intervention because they believed that it was not in the shareholder s long-term interests. However, there is strong evidence that the directors interests were more self-serving and, more worryingly, that the courts tried their hardest to accommodate the directors views. These concerns arose for the following reasons.

Firstly, the Time management had negotiated for themselves exceptionally favourable remuneration packages. Secondly, the merger had not been negotiated for two years. The involvement of Paramount meant that a new deal had to be constructed very quickly, and it was this deal which was proceeded with. Thirdly, it is difficult to see how any rational person could ignore the fact that the Paramount offer carried with it a 60% increase in capital. Such a company is almost certain to make more money and such an offer would certainly be more attractive to the shareholders. Finally, by accepting the Warner deal, the management declined the possibility to be equity-heavy in favour of automatically becoming debt-ridden.

The question arises why did the court accede to such an arrangement. It is contended that this is an example of the so-called race to the bottom. Despite being a tiny state, Delaware accommodates two-thirds of the Fortune 500 because its company laws are so liberal. Decisions such as this contribute to the Delaware Factor and encourage companies to incorporate there, in the full knowledge that both statute law and the common law will be sympathetic to their agendas.

[60] [1992] BCLC 192. See also the recent Australian case of *Brunninghausen v Glavanics* (1999) 17 ACLC 1247. Here, the company in question had issued 6,000 shares; 5,000 of which belonged to the sole effective director, Brunninghausen. The remaining 1,000 belonged to the dormant director Glavanics. Over time their relationship soured and Glavanics set up a business directly in competition with Brunninghausen s business. However, he did not resign his original directorship. Eventually, the two men attempted to resolve matters and Glavanics offered to resign his directorship and sell his shares providing that he was given a fair price.

However, unknown to Glavanics, Brunninghausen had received an unexpected offer from a third party to buy the assets of the company. Subsequently, Glavanics sold his shares to Brunninghausen for a price well below the price offered by the third party. When Glavanics found out, he sued Brunninghausen alleging breach of fiduciary duty.

At first instance, Bryson J agreed with the plaintiff. Brunninghausen, as a director, owed a fiduciary duty to Glavanics as a shareholder, and that Brunninghausen had, in failing to disclose this offer, breached that duty. Brunninghausen was ordered to pay A$300,000 to Glavanics.

Brunninghausen appealed and although the New South Wales Court of Appeal permitted the appeal regarding the quantum of damages, it dismissed the appellant s contention that there was no direct fiduciary duty between company and shareholder. For comment, see G. Stapledon & J. Webster, *Directors Duties and Corporate Governance* (1999) 17 C&SLJ 462; R. Goddard, *Percival v Wright: The End of A Remarkable Career?* (2000) 116 LQR 197.

[61] *Ibid.* at p.208.

[62] *Ibid.*

heavily criticised, the courts have been careful not to overrule it.[63] In the *Brunninghausen* case, although the court declined to follow *Percival*, it did not doubt the correctness of the principle that fiduciary duties were owed to the company. Accordingly, it is still the case that as a general rule, *Percival* still represents good law.[64] The exceptions discussed above appear to remain confined to certain special facts. *Percival* has enjoyed a remarkable career for a lower court decision. [65] For a while longer, its principle will remain a general rule and directors will only owe fiduciary duties directly to shareholders in certain circumstances.

Conclusion.

It is clear that the directors duties operate largely to protect the shareholders. The shareholders are the beneficiaries of the *bona fide* duty whilst the company is solvent. However, it is unclear why this is so. The courts have never provided an acceptable reason why the shareholders should be the exclusive beneficiaries of the duty. Further, it is curious to note how accepted this issue is despite the highly questionable nature of the authority. It could be argued that this prioritising of the shareholders, despite a lack of any clear justification, is due to our aforementioned reluctance to abandon the ownership model of the company and as such, we grant the shareholders almost exclusive legal protection despite no convincing justification for doing so. The word almost is used because in the last two decades, there have been developments that have served to introduce some form of legal protection to other groups within the corporate nexus. This first began in the late 1970 s when a number of academics voiced the opinion that creditors also needed some form of company law protection. Accordingly, the position of the creditor and the protection offered to them will now be examined.

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[63] *E.g.* *Re Chez Nico (Restaurants) Ltd.* [1992] BCLC 192 at 208, *per* Browne-Wilkinson VC; *Glandon Pty. Ltd. v Strata Consolidated Pty. Ltd.* (1993) 11 ACSR 543 at 548, *per* Mahoney J and *Crindle Investments v Wymes* [1998] 2 ILRM 275 at 288, *per* Keane J.

[64] *Cf.* Comment, *The Last Rites for Percival v Wright?* (2000) 21 Co.Law. 261 at 261 where it is stated that *Percival v Wright* can be safely confined to history.

[65] L. Loss, *The Fiduciary Concept as Applied to Trading By Corporate Insiders in the United States* (1970) 33 MLR 34 at 40.

II. LIMITED LIABILITY AND THE POSITION OF CREDITORS

The Creditor and Limited Liability.

S.2 Bubble Act Repeal Act 1825[66] contains what is thought to be the first attempt in English law to systematically introduce limited liability.[67] This provision tackled the issue at the source by persuading the Crown to grant more charters of incorporation by conferring wider Crown powers in relation to the granting of limited liability.[68] The Crown was no longer hamstrung into choosing between full limited liability or unlimited liability. There now existed a discretion as to any limit on liability. The amount could be below a member s initial contribution or above the amount, allowing for a decrease in limited liability.

However, what happened in reality, was that public opinion, faced with the possibility of a rapid rise in the number of chartered limited liability companies, turned against an extension of limited liability and became concerned with the position of creditors. Accordingly, the Crown responded by using its discretion to withhold limited liability in many charters. Paradoxically therefore, England s first attempt to facilitate limited liability was accompanied by the first time that limited liability was viewed as unpopular.

Despite a brief resurgence in the popularity of limited liability, public opinion again hardened and it was withheld from the Companies Act 1844.[69] However, the depression of 1845-48 drew attention to the plight of shareholders with personal liability to such an extent that limited liability was back in favour by the mid-1850 s. In 1852, the Court of Exchequer Chamber acknowledged the validity of a limited liability clause.[70] Finally, following two select committees and a Royal Commission,

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[66] (1825) 6 Geo IV, Cap XCI.

[67] Prior to this Act, limited liability could only be granted to individual companies through an express provision in the Royal Charter of Incorporation or by Act of Parliament.

[68] S.2 Bubble Act Repeal Act 1825:

> the Members of such Corporation shall be individually liable, in their Persons and Property to such Extent, and subject to Such Regulations and Restrictions as His Majesty may deem fit and proper, and as shall be declared and limited in by such Charter.

[69] 7 and 8 Vict. c.110.

[70] *Hallett v Dowdall* (1852) 21 LJQB 98.

Parliament passed the Limited Liability Act 1855[71] and its liberal successor, the Joint Stock Companies Act 1856.[72]

Even after limited liability was attained, the Commonwealth legislatures and subsequently the courts, still attempted to impose some safeguards to protect creditors. These safeguards usually took the following forms.[73] Companies were required to adopt a suffix (*e.g.* Limited, Ltd., Incorporated, Inc.) as part of the company s name. There had to be at least 25 members[74] holding £10 shares paid to at least £2. There were filing requirements involving the company s name, addresses of company directors and the company s constitution. The doctrine of *ultra vires*, developed judicially by the House of Lords in *Ashbury Railway Carriage and Iron Co. v Riche*,[75] derogated the company s powers via the company s memorandum. Finally, the courts imposed fiduciary obligations of skill and care on company directors, although, at the time, these obligations were extremely limited.[76]

However, in reality, these limits were ineffective and were an inadequate trade-off for the shareholder s limited liability.[77] The disclosure requirements for the company s name were never taken very seriously, and in any case did little to aid the creditor. The *ultra vires* doctrine was easily circumvented and could serve to hinder creditors as often as it aided them. Any fiduciary duties were owed to the company and not to creditors.[78] The duties of skill and care were notoriously lax and in many cases non-existent. In any case, any breach of duty was ratifiable by the shareholders.[79]

Accordingly, it has been contended that the concept of limited liability favours the shareholders at the expense of the creditors. Limited liability shifts the risk of business failure from the shareholders onto the creditors, thereby creating an

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[71] 18 and 19 Vict. c. 133.
[72] 19 and 20 Vict. c. 47.
[73] J.S. Ziegal, *Is Incorporation (with Limited Liability) Too Easily Available?* (1990) 31 *Cahiers de Droit* 1075 at 1085-8.
[74] The 25 member requirement of the 1855 Act was lowered to 7 by the 1856 Act.
[75] (1875) LR 7 HL 653.
[76] *E.g.* see the cases of *Re Denham & Co.* (1883) 25 Ch.D. 752; *Re Cardiff Savings Bank* [1892] 2 Ch. 100 and *Re Brazilian Rubber Plantations & Estates Ltd.* [1911] 1 Ch. 425.
[77] J.S. Ziegal, *Is Incorporation (with Limited Liability) Too Easily Available?* (1990) 31 *Cahiers de Droit* 1075 at 1088-9.
[78] *Percival v Wright* [1902] 2 Ch. 421; *Re Smith & Fawcett Ltd.* [1942] Ch. 304.
[79] *Hogg v Cramphorn* [1967] Ch. 254; *Bamford v Bamford* [1968] 2 All ER 655.

externality. Creditors who lend to a limited liability company are at risk as the principle of limited liability creates a perverse incentive for an insolvent company to continue to trade. [80] As a company approaches insolvency, the shareholders know that their investment may already be lost, so they have an incentive to gamble with the assets that are left. If the gamble goes well, the company may again become solvent. However, if the gamble fails, the shareholders are protected by their limited liability. The creditors, conversely, will probably discover that this final gamble will have eliminated all chance that they have of being paid. Accordingly, as insolvency approaches, it becomes rational for a company to make an investment which is riskier but alone offers the possibility, albeit remote, of a bonanza payoff that will prevent insolvency. [81]

Do Creditors Need Further Legal Protection?

Before examining the extent to which the law affords protection to a company s creditors, it is worth noting that creditors may not actually need any form of legal protection. The traditional position, as we have seen, is that limited liability serves to weaken the creditor s position. Accordingly, limited liability results in uncompensated risk being imposed on creditors who deal with the company. [82] Therefore, when examining whether the creditors need further protection, we are attempting to define what risks the creditors of a corporation have not agreed to accept in their dealings with it. [83] However, whether creditors suffer from uncompensated risk or not is open to debate.

As this chapter is concerned with the protection offered by the law, not whether or not that protection is warranted, this issue will not be examined here. However in Chapter 7, the creditor s ability to protect themselves by contract will be examined in detail. It will be seen that the academic perception that the creditors are helpless to protect themselves is not entirely accurate and that the risk faced by them is not

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[80] D.D. Prentice, *Creditor s Interests and Director s Duties* (1990) 10 OJLS. 265 at 265.

[81] J.C. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web* (1986) 85 Michigan LR. 1 at 61.

[82] D.D. Prentice, *Corporate Personality, Limited Liability and the Protection of Creditors* in R. Grantham & C. Rickett (eds.), *Corporate Personality in the 20th Century*, 1998, Oxford: Hart Publishing, p.104.

[83] J. Dabner, *Trading While Insolvent - A Case for Individual Creditors Rights Against Directors* (1994) 17 UNSWLJ 546 at 574-5.

always uncompensated. It is worth bearing this in mind when examining the protection offered by the law.

The Traditional Position.

As we have noted, traditionally a director s duties are owed to the company alone and not to the shareholders.[84] On this the Jenkins Committee[85] said no fiduciary duty is owed by a director to individual members of his company, but only to the company itself, and *a fortiori* that none is owed to a person who is not a member. [86] Accordingly, in *Multinational Gas and Petrochemical Co.Ltd. v Multinational Gas and Petrochemical Services Ltd.*,[87] Dillon LJ held that [t]he directors owe fiduciary duties to the company though not to the creditors, present or future, or to individual shareholders. [88]

Judicial Developments.

Although, there exist pre-World War II judgments indicating that creditor protection is within the scope of directors duties,[89] 1976 was the major turning point as regards judicial acknowledgment of creditors rights. Impetus came from the Australian case of *Walker v Wimborne*.[90] In that case, a father and his sons were directors of several companies and administered them as a group. A liquidator of one of these companies, Asiatic Electric Co. Pty. Ltd., challenged a payment of A$10,000 from Asiatic to another one of the companies, Australian Sound & Communications Pty. Ltd. The sole reason for this payment was that the company needed the money. However, the second company was clearly incapable of paying the loan off. Mason J, speaking for the majority, said:

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[84] *Percival v Wright* [1902] 2 Ch. 421.
[85] *The Report of the Company Law Committee*, 1962, Cmnd. 1749, London: HMSO.
[86] *Ibid.* at para.89.
[87] [1983] Ch. 258.
[88] *Ibid.* at p. 288.
[89] In the American case of *Pepper v Litton* 308 U.S. 295 at 307 (1939), Douglas J stated:

> the standard of fiduciary obligation is designed for the protection of the entire community of the interests of the corporation - creditors as well as stockholders.

For more on the American position, see *Northern Mining Corp. v Cooke Mining* 123 F.Supp. 9 (9th Cir.) (1941); *New York Credit Men s Adjustment Bureau v Weiss* 119 NE 2d. 397 (1953); *A & K Railroad Materials v Green Bay Western Railroad Co.* 437 F.Supp. 636 (1977); *Dannen v Scafdi* 393 NE 2d. 1246 (1979); *Francis v United Jersey Bank* 432 A 2d. 814 (1981); *Hahn and Hupf Construction v Highland Heights Nursing Home* 393 NE 2d. 1246 (1986).
[90] (1976) 50 AJLR 446.

> it should be emphasised that the directors of a company in discharging their duty to the company must take into account of the interests of its shareholders and its creditors . The transaction offered no prospect of advantage to Asiatic, it exposed Asiatic to the probable prospect of substantial loss, and thereby seriously prejudiced the unsecured creditors of Asiaitc. [91]

This trend was followed in a number of cases in New Zealand[92] and Australia.[93] However, there then followed a period of confusion as to when the interests of the creditors displace or compliment the duty to the shareholders. In particular, did the company in question need to be insolvent for, as was noted in Grove v Flannel,[94] although the company in Walker was insolvent, Mason J did nothing to suggest that this was a prerequisite. Accordingly, in Ring v Sutton,[95] the New South Wales Court of Appeal held that the principle was applicable where the company was clearly solvent, whereas the Court of Appeal in Re Horsely & Weight Ltd.[96] held that the insolvency was a prerequisite. Finally, it was held that insolvency was required in the case of Kinsela v Russell Kinsela Pty.[97] In that case, Street CJ held that:

> In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise . But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled to displace the power of the shareholders and directors to deal with the company s assets. [98]

These commonwealth principles first permeated English law in 1980 in the case of Lonhro Ltd. and Another v Shell Petroleum Ltd. and Another.[99] Here, Lord Diplock stated that the interests of the company are not exclusively those of shareholders but may also include those of creditors. [100]

More notably, in the case of Winkworth v Edward Baron Development Co.,[101] Lord Templeman held:

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[91] *Ibid.* at p.449.
[92] *Re Avon Chambers Ltd.* [1978] 2 NZLR 638; *Nicholson v Permakraft (NZ) Ltd.* [1985] 1 NZLR 242; *David Neil & Co. Ltd. v Neil* (1986) 3 NZCLC 99,658; *Re Lake Tekapo Motor Inn Ltd. (in Liq.)* (1987) 3 NZCLC 100,156; *Hilton International Ltd. (in Liq.) v Hilton* [1989] NZLR 442.
[93] *Ring v Sutton* (1980) 5 ACLR 546; *Grove v Flavel* (1986) 43 SASR 410; *Jeffree v NCSC* (1989) 15 ACLR 217.
[94] (1986) 43 SASR 410 at 410, *per* Jacobs J.
[95] (1980) 5 ACLR 546.
[96] [1982] 3 All ER 1045.
[97] (1986) 4 NSWLR 722.
[98] *Ibid.* at p.730.
[99] (1980) 1 WLR 627.
[100] *Ibid.* at p.634.
[101] [1987] 1 All ER 114.

> a company owes a duty to its creditors present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. [102]

Similar approaches were evidenced in the cases of _*Brady v Brady*_[103] and _*West Mercia Safetywear Ltd. v Dodd*_.[104] In the latter, _Kinsela_ was approved and there have been no major judicial developments since.

The question that now occupies us is to what extent do these cases establish a duty and how is that duty to operate. This is an important question as the Company Law Review Steering Group has considered the possibility of incorporating this duty into their statutory statement of directors duties.[105] At first glance, these cases appear to offer the creditors some effective legal protection. However, when examined more closely, one can conclude that this duty to creditors is unlikely to affect the legal model of the company.[106]

Firstly, many of the aforementioned comments relating to directors duties to creditors were only *obiter dicta*, which of course, are not binding in authority, only persuasive. It has, therefore been contended that in future cases, they will not be followed as the principle in _*Percival v Wright*_ is too well-established to be overturned by a principle born out of mere *dicta*.[107] Similarly, this duty could form a potential exception to the principle of limited liability, and should not be followed, lest it emasculate a principle central to our economy s well being.[108]

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[102] *Ibid.* at p.118. The position is similar in America. See _Credit Lyonnais Bank Nederland N.V. v Pathe Communications Corp. 1991 Westlaw 277613 (1991)_.

[103] _[1987] 3 BCC 535 at 552_, *per* Nourse LJ: where the company is both going and solvent, first and foremost come the shareholders Conversely, where the company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of the existing creditors alone.

[104] _[1988] BCLC 250_.

[105] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, 2001, London: DTI, para. 3.13.

[106] See V. Finch, *Directors Duties Towards Creditors* (1989) 10 Co.Law. 23 at 24 who contends that these cases do not [create] duties that are workable in the practical world.

[107] C.A. Riley, *Directors Duties and the Interests of Creditors* (1989) 10 Co.Law. 87 at 91. However, as will be seen later, the possibility of a direct fiduciary duty to shareholders may have weakened the principle in _*Percival v Wright*_.

[108] See L.S. Sealy, *Directors Duties - An Unnecessary Gloss* (1988) CLJ 175 at 176 who, referring to the judgments in the above cases states that it is not an exaggeration to say that if sentiments like this had prevailed over the past century and a half, the limited liability company would never have got off the ground.

Secondly, is the duty owed to creditors directly or is it owed to the company? This is important because if it is the latter, then only the company will be able to bring an action for breach. One could argue that if creditors cannot bring an action, then the value of the duty will be lessened. However, there are strong reasons for arguing that the duty should be mediated through the company. Firstly, it will eliminate the possibility of double-recovery. If a creditor could sue for breach, then it may be that a directors act that was a breach of his duty to creditors could also constitute a breach of his duties to the company for which both the company and the creditor could sue. Secondly, mediation through the company preserves the principle of *pari passu* that all creditors should be treated equally, since no one creditor will gain an advantage by being the first to sue.[109] Finally, by denying creditors a direct action, the courts are preserving the procedural monopoly of liquidation proceedings for dealing with the claims of creditors against an insolvent company.[110]

Until recently, it was not sure whether or not this duty was owed directly to creditors or not. In *Winkworth v Edward Baron Co*.,[111] Lord Templeman stated that the board owed a duty to the company and to the creditors of the company [to] keep its property inviolate an available for the repayment of its debts. [112] However, it is now clear that creditors have no cause of action following the case of *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*.,[113] where Lord Lowry held that [a] director does not by reason only of his position as director owe any duty to creditors or to trustees for creditors of the company. [114]

Third, irrespective of whom the duty is owed to, there is concern that the duty comes into effect too late to be of any real aid to the creditors. There is a view emerging that the directors should be bound to take into account the risks that creditor face at an

[109] D.D. Prentice, *Corporate Personality, Limited Liability and the Protection of Creditors* in R. Grantham & C. Rickett (eds.), *Corporate Personality in the 20th Century*, 1998, Oxford: Hart Publishing, p.108.
[110] D.D. Prentice, *The Effect of Insolvency on Pre-Liquidation Transactions* in B.G. Pettet (ed.), *Company Law in Change*, 1987, London: Stevens, pp.69-70.
[111] [1987] 1 All ER. 114.
[112] *Ibid.* at p.118.
[113] [1991] 1 AC 187. A Privy Council decision, but since confirmed in *Yukong Line Ltd. v Rendsburg Investments Corporation (No. 2)* [1998] 1 WLR 294.
[114] *Ibid.* at p.217.

earlier stage.[115] Such a view has been taken in a number of Australasian cases[116] as well as in Delaware.[117] This would require directors to take steps to reduce the risks of creditors when there was *a substantial probability of an insolvent liquidation*. The greater the probability, the more weight is given to the interests of creditors and less weight given to the interests of members. At the point where there is no prospect of avoiding liquidation, the interests of the creditors should completely override the interests of the members. It is contended that such a rule would provide a more effective balance between the interests of creditors and members.

Finally, a number of academics argue that a common law duty to creditors is unnecessary and potentially pernicious [118] as they are adequately protected via existing legal mechanisms[119] or, more notably statutory measures such as s.214 Insolvency Act 1986 and the provisions of the Company Directors Disqualification Act 1986. However, as we shall see, these statutory protective measures have shown themselves no more effective in protecting creditors than the case law developments.

In its Final Report, the Company Law Review Steering Group considered the possibility that the above duty to take creditor interests into account when the company nears insolvency should be incorporated into the statutory statement of directors duties.[120] However, we have seen that there are a substantial number of problems with this duty that serve to weaken its operation. To date, these weaknesses have not been overcome. This would go a long way towards explaining why the government, in its recent White Paper on a new Companies Bill, has decided not to include a duty to creditors in its statutory statement of directors duties.[121]

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[115] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, 2001, London: DTI, para. 3.17.

[116] *Nicholson v Permakraft* [1985] INZLR 242; *Kinsela v Russell Kinsela Pty. Ltd.* [1968] NJWLR 722.

[117] *Credit Lyonnais Bank Nederland N.V. v Pathe Communications Corps.* [1991] WL 277613 [Del. Ch. 1991].

[118] L.S. Sealy, *Directors Duties - An Unnecessary Gloss* (1988) CLJ 175 at 177.

[119] *Ibid.* at p.175 who states that it will be seen that in most cases they are nothing more than extraneous words of censure directed at conduct which anyway comes within some well-established rule of law, such as the law imposing liability for misfeasance, the expropriation of corporate assets or fraudulent preference.

[120] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, 2001, London: DTI, para. 3.13.

S.214 Insolvency Act 1986: Wrongful Trading.

The risks that creditors face was the subject of the Report of the Cork Committee in 1982.[122] The Committee recognised a clear need to protect creditors who had suffered as a result of reckless or unreasonable behaviour of company directors.[123] At the time of the report, s.332 Companies Act 1948 provided for liability for fraudulent trading. Under this section, directors who had caused the company to trade fraudulently could be ordered to pay to the company an amount fixed by the court. If during the course of a winding up, the court considered that a director was guilty of fraudulent trading then not only did this create a civil and personal liability, it also resulted criminal liability. Accordingly, a strict standard of proof was required, which resulted in few applications being successful. There was also a need to show dishonest or fraudulent behaviour on the part of the director.[124] The Cork Committee concluded that this was the main reason why the section was ineffective.[125] If a director was acting honestly then he would be innocent irrespective of any recklessness or negligence.

Given the failings of s.332, the Cork Committee proposed a new civil liability for wrongful trading which is now found in s.214 Insolvency Act 1986 and, according to one commentator, constitutes what is probably the most extreme departure from the rule in *Salomon s* case yet achieved in the United Kingdom. [126] Creditor protection was becoming a significant concern given the increasing number of liquidations. In 1980, there were 6,890 company liquidations. In 1982, the year the Cork Committee reported, this figure had risen to 12,067.[127]

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[121] DTI, *Modernising Company Law,* July 2002, Cm. 5553-I. London: DTI, para.3.10.

[122] *Report of the Review Committee on Insolvency Law and Practice*, 1982, Cmnd. 8558, London: HMSO.

[123] *Ibid.* at para. 1777: [c]ompensation ought, in our view, to be available to those who suffer foreseeable loss as a result not only of fraudulent, but also unreasonable behaviour.

[124] *Re Patrick & Lyon Ltd.* [1933] Ch. 786; *R v Grantham* [1984] QB 674.

[125] *Report of the Review Committee on Insolvency Law and Practice*, 1982, Cmnd. 8558, London: HMSO, para. 1776.

[126] P.L. Davies, *Gower s Principles of Modern Company Law*, 1997, 6th ed., London: Sweet & Maxwell, p. 151. See also D.D. Prentice, *Creditor s Interests and Director s Duties* (1990) 10 OJLS 265 at 277 who describes s.214 as unquestionably one of the most important developments in company law this century.

[127] C. Cook, *Wrongful Trading — Is It A Real Threat to Directors or A Paper Tiger?*(1999) 3 Insolv. L. 99 at 99.

Under s.214, a court may declare a director or a shadow director[128] of a company liable to contribute to the assets of the company if the director knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation,[129] and did not take every step to minimise the potential loss to the company s creditors. A finding of s.214 may also lead to disqualification[130] as has occurred in several cases.[131]

In relation to creditors, the theoretical aims of s.214 are obvious. As has been noted, limited liability creates an incentive to trade even when the company is unlikely to avoid insolvency. Trading at such a time could have the effect of dissipating any assets that could have been used to pay the creditors. S.214 was meant to counter this incentive by establishing personal liability should the directors continue to trade in such a situation, thereby ensuring that there are at least some funds left inviolate to pay the creditors.

However, the reception that s.214 has received since its enaction has been mixed, and there is now a general feeling emerging that s.214 has not achieved the objectives that it was created for.

A significant problem concerns the vague nature of the provision. The test for breach of s.214 is that a director knew or ought to have known that there was no reasonable prospect of avoiding insolvent liquidation. Accordingly, it can be seen that the test contains both an objective and subjective element. This test should be read in conjunction with s.214(4) which also contains objective and subjective elements. In applying objective standards to company directors in this way, s.214 breaks new ground. [132] These objective standards in effect establish a minimum standard for directors to adhere to. For over a century the emphasis in the case law has always

[128] The term shadow director is defined in s.741 Companies Act 1985; s.251 Insolvency Act 1986, and s.22(5) Company Directors Disqualification Act 1986.

[129] Insolvent liquidation is defined in s.214(6) Insolvency Act 1986 as the time when the company s assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

[130] S.10 Company Directors Disqualification Act 1986, discussed *infra*.

[131] See *e.g.* *Re Purpoint Ltd* [1990] II & P 72; *Re Brian D Pierson (Contractors) Ltd* [1999] B.C.C. 26.

[132] L.S. Sealy, *Disqualification and Personal Liability of Directors*, 1993, 4th ed., London: CCH Editions Ltd., *f* 607.

been on the need for honesty rather than any degree of skill or ability.[133] This change is underlined by s.214(5) which puts blameworthy omissions on par with blameworthy commissions: if the director does not carry out any functions which have been entrusted to him, he is to be judged by the same criteria as if he had. Again this is a departure from the common law which has never had effective sanctions to penalise passive defaults such as non-attendance at board meetings.[134]

The problem is that whilst s.214 is to be applauded for introducing a more effective standard, it provides no guidance as to how directors should adhere to it. The approach of the legislators is based on a somewhat large and highly questionable assumption, namely that when insolvency looms, the interests of the company s creditors are best served by putting the company into voluntary liquidation or receivership, or by seeking an administration order, as soon as possible. These proceedings are notoriously costly and creditors may actually lose out from a forced sale of assets. S.214 does not permit directors to take this into account, nor the effect that a premature liquidation may have on the company s employees and customers. In the absence of such guidance, there is a real fear that directors may panic and put their companies into premature receivership or liquidation rather than nurse them back into profit.[135] In order to avoid the consequences of s.214, directors who do decide to carry on trading should ensure that their decision is fully reasoned and documented, and, if the board lacks experience, with the backing of professional advice. Further, since s.214 extends to former directors as well as those in office, a director cannot avoid liability simply by resigning. However, a minority director who cannot persuade his fellow directors to take proper precautions may have no other option but to have his dissent recorded and resign.[136] This is because he has on his own no standing to apply for a winding up order or to initiate a voluntary arrangement.

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[133] *E.g.* Re City Equitable Fire Insurance Co. Ltd. [1925] Ch. 407.
[134] L.S. Sealy, *Disqualification and Personal Liability of Directors*, 1993, 4th ed., London: CCH Editions Ltd., *f* 607.
[135] See *e.g.* A. Hicks, *Wrongful Trading — Has It Been A Failure?*(1993) 8 Insolv. L. & Prac. 134 at 135; P. Farmery, *The Insolvency Act and the Corporate User Part 2* (1986) BLR 4 at 4.
[136] A director would be advised to resign rather than simply take no further part in the company s management because this could give rise to a breach of his service contract.

It may be because of the uncertainties mentioned above that during the period 1986-1993, only four s.214 cases made it to court.[137] This was so despite the fact that between 1989 and 1993, there were over 92,500 corporate insolvencies in England and Wales.[138] Another significant factor inhibiting the usefulness of the offence is the issue of funding. While creditors may often urge liquidators to bring proceedings under s.214, the expenses involved ensure that financial reasons alone stop most potential claims before they start. Two additional factors compound the funding problem. Firstly, it was held by Millett J in *Re MC Bacon Ltd. (No. 2)*[139] that the costs of an unsuccessful wrongful trading action cannot be regarded as liquidation expenses and therefore a liquidator should be confident of success before commencing an action. A liquidator may therefore need to secure outside funding and this will only be forthcoming if the action is likely to be successful. The only other alternative is for the liquidator to pay the costs himself and this he will be highly unlikely to do. One commentator has noted that [t]he paucity of funds available to pursue a wrongful trading claim goes to the heart of its effectiveness [140] and as a result of the decision in *Re MC Bacon*, s.214 is little more than a paper tiger. [141]

Secondly, even if an action is successful, it is highly likely that the directors will have no personal assets to contribute to the company.[142] Given these uncertainties, many creditors would rather accept what little monies they can get rather than jeopardise their return even further with a speculative wrongful trading action.

Another area of ambiguity concerns the actual nature of s.214, namely is it compensatory or punitive in nature. Concerning this, the Cork Committee stated:

> It is right that it should be an offence to carry on a business dishonestly; and right that, in the absence of dishonesty, no offence should be committed. Where, however, what is in question is not the punishment of an offender, but the provision of a civil remedy for those who have suffered financial loss, a requirement that dishonesty be proved is inappropriate. Compensation ought, in

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[137] P. Godfrey and S. Nield, *The Wrongful Trading Provisions — All Bark and No Bite?*(1995) 11 Insolv. L. & Prac. 139 at 149.
[138] *Ibid.*
[139] [1990] BCLC 324.
[140] C. Cook, *Wrongful Trading — Is It A Real Threat to Directors or A Paper Tiger?*(1999) 3 Insolv. L. 99 at 103.
[141] *Ibid.*
[142] See A. Hicks, *Advising on Wrongful Trading: Part 1* (1993) 14 Co.Law. 16 at 16: Directors of companies in financial difficulty are often in financial difficulty themselves, so it may not be worth obtaining an order against them.

> our view to be available to those who suffer foreseeable loss as a result, not only of fraudulent, but also of unreasonable behaviour. [143]

It is clear given the above that s.214 is intended to be compensatory rather than punitive.[144] However, the language and the operation of the section does not reflect this. The use of the word wrongful implies that the director is being blamed for the way he has treated the creditors.[145] Several commentators have stated that any director subject to a s.214 action will feel that he has been punished rather than compensating the company.[146]

A further problem is the lack of flexibility given to the liquidator in terms of monies accrued as the result of s.214. Any contribution ordered by the court under s.214 simply swells the company pool and the liquidator must then disperse the assets in the order prescribed by law.[147] Neither the court nor the liquidator have any discretion. In the normal case, where the directors have been found guilty of offences under ss.213-4, all the company s creditors will be affected and so it is right that they should be treated equally. However, this is not always the case, but s.214 does not recognise this. It may be the case that not all creditors will suffer loss to the same extent. For example, if a company owes money to both a bank and a trade creditor, the effect of a contribution under s.214 will benefit both. However, if the bank had been able to secure a personal guarantee from the directors, the court will not be able to take this into account. Yet payment to the bank out of the swelled pool will reduce the directors liability under the guarantee. If the court had more flexibility and were intent on protecting those who had suffered loss from the abuse of limited liability, then they could recognise that the bank had avoided the consequences of limited liability (by taking the guarantee) and so compensate those who have suffered loss.[148]

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[143] *Report of the Review Committee on Insolvency Law and Practice*, 1982, Cmnd. 8558, London: HMSO, para. 1777.
[144] See Re Produce Marketing Consortium Ltd. [1989] BCLC 520, per Knox J: In my judgment the jurisdiction under section 214 is primarily compensatory rather than penal.
[145] P. Godfrey and S. Nield, *The Wrongful Trading Provisions — All Bark and No Bite?*(1995) 11 Insolv. L. & Prac. 139 at 140-1.
[146] C. Williams, *Section 214 of the Insolvency Act 1986 and the Private Company: Why It May Fall Short of the Mark* (1990) 11 Co.Law. 222 at 223.
[147] S.175 Insolvency Act 1986 and r.4.181 Insolvency Rules 1986.
[148] C. Williams, *Section 214 of the Insolvency Act 1986 and the Private Company: Why It May Fall Short of the Mark* (1990) 11 Co.Law. 222 at 224.

Another inhibiting factor is that all but the largest and smallest or corporate borrowers will usually have issued floating charges to their bank lenders. Such companies are often reliant on the support of the bank. If it is withdrawn, the bank will appoint a receiver who will administer the company s assets. The relevant point here is that it is only liquidators, not receivers, who can bring a wrongful trading action. Accordingly, where a receiver becomes involved no s.214 action will be brought even though the directors may be guilty of the offence.

The final problematic area concerns the defence to s.214 contained in s.214(3). S.214(3) directs the court not to make a declaration of personal liability against a person if it is satisfied that, after the time when he first knew or ought to have known that there was no reasonable prospect of avoiding insolvent liquidation, he took every step with a view to minimising the loss to the company s creditors as he ought to have taken. Several commentators have correctly noted that this defence is going to be very difficult to apply in practice. First, when the court attempts to determine what the director ought to have done, they will do so crediting him with an awareness of the company s financial position and also with a general degree of skill and experience that he may not in fact have. This fictitious assumption of the director s state of mind is likely to cause difficulties for the court.[149]

Second, neither the legislature nor the courts give any hint as to what steps should be taken. Numerous academics[150] and bodies[151] have offered guidelines, but they are careful to point out that this is all they are and should not be regarded as absolute. Directors, fearful of acting without this knowledge, may decide simply to resign. However, this will not terminate their liability. On the contrary, the courts may take the view that resignation precludes him from taking the necessary steps to minimise losses, and his obligation is to remain in office and fight for the creditor s interests from within.[152] Many directors will assume that the interests of the creditors will be best served by placing the company into voluntary liquidation, and indeed as we have noted, premature liquidations are a major fear for those critics of s.214. It may be the

[149] L.S. Sealy, *Disqualification and Personal Liability of Directors*, 1993, 4th ed., London: CCH Editions Ltd., *f* 608.
[150] See *e.g.* R. Whitehouse and T. Arnold, *Protecting Yourself as a Director of a Company in Difficulties* (1993) 137 SJ. 218.
[151] See *e.g.* The Institute of Directors, *Companies in Financial Difficulties*, London: IoD.

case, however, that ceasing to trade may not be the best option for the creditors, even in situations where it is not possible to save the company. Selling the company as a going concern may yield more than a forced sale of assets. Further, there is evidence that directors who take this course may be permitted to sell the business at an undervalue (which is normally a breach of duty) if they honestly believe that to do so may save the business.[153] There are also the option of administration and voluntary arrangements available to directors.

Finally, there is confusion as to who bears the onus of proof. Many academics assume that the onus is placed on the director to show that he did all that he could to minimise the losses to creditors.[154] However, one leading academic has contended that the onus is in fact on the liquidator to demonstrate what steps the director ought to have taken. [155]

These difficulties in applying the defence are likely to be compounded when one considers that s.214(3) is the only defence to a s.214 claim. The courts have held that the discretionary defence found in s.727 Companies Act 1985[156] does not apply in the case of wrongful trading actions.[157]

The Cork Committee, when justifying the new concept of wrongful trading, stated:

> A balance has to be struck. No one wishes to discourage the inception and growth of businesses, although both are unavoidably attended by risks to creditors. Equally a climate should exist in which downright irresponsibility is discouraged and in which those who abuse the privilege of limited liability can be made personally liable for the consequences of their conduct. We believe that our proposals in this chapter strike a balance between these two conflicting needs. We regard them as of the greatest importance as a matter of urgent necessity. [158]

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[152] A. Hicks, *Advising on Wrongful: Trading: Part 2* (1993) 14 Co.Law. 55 at 58.
[153] *Re Welfab Engineers Ltd.* [1990] BCC 600.
[154] See *e.g.* R.R. Pennington, *Pennington s Company Law*, 1995, 7th ed., London: Butterworths, p.54; J.H. Farrar & B.M. Hannigan, *Farrar s Company Law*, 1998, 4th ed., London: Butterworths, p.739.
[155] L.S. Sealy, *Disqualification and Personal Liability of Directors*, 1993, 4th ed., London: CCH Editions Ltd., *f* 608.
[156] This allows the court to excuse a director where he had acted honestly and he ought to be excused.
[157] *Re Produce Marketing Consortium Ltd.* [1989] BCLC 513.
[158] *Report of the Review Committee on Insolvency Law and Practice*, 1982, Cmnd. 8558, London: HMSO.

There is a general recognition amongst commentators that the aims of the Cork Committee have not been have not been met by the wrongful trading provision.[159] The vagueness of the provision coupled with the ineffectiveness of its only defence ensure that it is of more use as a deterrent than as an actual mechanism for compensating creditors. It is, however, the problem of funding wrongful trading claims that ultimately reduces the usefulness of s.214; a reduction that is clearly demonstrated by the low number of s.214 claims that have reached court. Accordingly, although s.214 is a provision designed to protect creditors, it does not protect them adequately.

Despite this, the Company Law Review Steering Group has recommended that s.214 in its current form could be included in the statutory statement of directors duties. They were unable to reach an agreement and so recommended further consultation on the matter.[160] The need for further consultation is apparent given that there are strong arguments on both sides.

There is little doubt that the incorporation of s.214 into the statement will provide a clear indication at the point which the duty to the shareholders is displaced. However, the CLRSG has indicated that the duty should come into effect before the onset of insolvency.[161] They believe that this is what good directors do anyway. Without such a rule directors would apparently be bound to act in the ultimate interests of members until all reasonable prospect of avoiding shipwreck has been lost.[162] Yet even where insolvency is uncertain, but the risk is substantial, the directors should be considering the interests of shareholders and creditors together.

The problem is that this will require the directors to balance the interests of shareholders and creditors. The CLRSG believes that this could have a chilling effect meaning that directors could run down or abandon a going concern at the first

[159] See *e.g.* C. Williams, *Section 214 of the Insolvency Act 1986 and the Private Company: Why It May Fall Short of the Mark* (1990) 11 Co.Law. 222 at 224; A. Hoey, *Wrongful and Reckless Trading — Remedies Without Substance?* (1995) 11 Insolv. L. & Prac. 50 at 52.
[160] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, 2001, London: DTI, para.3.20. However, in para.3.16 the CLRSG appear to state that they do wish to recommend incorporation of s.214 into the draft statement.
[161] *Ibid.* at para.3.17.
[162] *Ibid.* at para.3.18.

hint of insolvency.[163] Given that s.214 results in personal liability, there is a real fear that many companies would be put into premature liquidation. If the company can be saved, the premature liquidation is as damaging to the creditors as to the shareholders. It will destroy the company s value and employment.

Given the above concerns, the CLRSG recommended further consultation. After further consultation the Government in its recent White Paper concluded that the arguments against incorporation of s.214 outweighed the arguments for incorporation. The Government was concerned that the risk of premature liquidations would destroy the rescue culture philosophy that the Insolvency Act 2000 and the new Enterprise Bill were trying to promote.[164] Accordingly, the Government recommended that s.214 remain in the Insolvency Act 1986 and not be incorporated into the statutory statement of directors duties.[165]

The Company Directors Disqualification Act 1986.[166]

The power to set up and run a limited liability company is one conferred by statute.[167] It has been contended that absolute power is vested, by means of art.70, Table A, Companies (Tables A to F) Regulations 1985,[168] in the board of directors.[169] Accordingly, the company has come to resemble the State with the directors acting as a self-perpetuating oligarchy. [170] Directors therefore have opportunities for fraud or self-gain, and stand in a position to affect all those with a stake in the company. In order to curtail such behavior, there exist regulatory measures and criminal

[163] *Ibid.* at para.3.19.
[164] DTI, *Modernising Company Law*, July 2002, Cm. 5553-I, London: DTI, para.3.11.
[165] *Ibid.* at paras.3.10-3.
[166] Hereafter CDDA.
[167] S.1 Companies Act 1985.
[168] Art.70, Table A, Companies (Tables A to F) Regulations 1985 (SI 1985/805):

> Subject to the provisions of the Act, the memorandum and the articles and to any directions given by special resolution, the business of the company shall be managed by the directors who exercise all the powers of the company

[169] A. Hicks, *Disqualification of Directors - Forty Years On* [1988] JBL 27 at 28. This contention that directors have absolute power is of course, incorrect. Provisions such as s.303 Companies Act 1985 ensures that there still remains, at least theoretically, a significant portion of residual power in the hands of the shareholders.
[170] *Ibid.*

penalties.[171] However, these provide only *ex post facto* control of directors actions, by which time the damage has been done.

In an effort to strengthen the current restraints on directorial power, in 1985, the legislature introduced a provision giving the court the power to disqualify delinquent directors, namely s.300 Companies Act 1985. However, there was significant dissatisfaction with this section given that disqualification could only occur if a director had been involved with two companies which both in the proceeding five years had gone into insolvent liquidation, and if his conduct as a director of either of those companies was thought to render him unfit to be a director of subsequent companies. Accordingly, this provision was repealed and replaced by the provisions of the Company Directors Disqualification Act 1986. Here, we are concerned with two sections, namely ss.6 and 10.

The majority of cases brought under the CDDA involve the question of unfitness under s.6:

> 6(1) The court shall make a disqualification order against a person in any case where, on an application under this section, it is satisfied-
> (a) that he is or has been a director of a company which has at any time become insolvent (whether while he was a director or subsequently) and,
> (b) that his conduct as a director of that company (either taken alone or taken together with his conduct as a director of any other company or companies) makes him unfit to be concerned in the management of a company.

In examining this provision, two issues will dominate, namely the issue of unfitness and the problems surrounding sanctions.

The first issue to be examined is how the courts decide if a director is unfit. Linked to this will be an examination of the ethos pervading the disqualification provisions, namely do they exist to protect the public or punish the director.

When determining unfitness, the courts must have regard to the factors set out in Schedule 1 of the Act.[172] However, these factors are not exhaustive[173] and therefore

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[171] There are over 200 offences in the Companies Act 1985: see J. Dine, *Personal Accountability and Corporate Control: The Role of Directors and Officers Liability Insurance* (1995) 58 MLR 880.
[172] S.9 Company Directors Disqualification Act 1986.
[173] *Re Bath Glass Ltd.* [1988] BCLC 329 at 332, *per* Gibson J.

the courts are generally left with the task of determining unfitness. Unfitness has emerged as the most important and controversial aspect of the CDDA.[174]

A major issue that has arisen is whether incompetence, as opposed to fraud or other deliberate or reckless wrongdoing, should constitute unfitness. This is a difficult question and one which requires the balancing of two potentially conflicting interests. On one hand, the purpose of the legislation is the ensure that those who take advantage of the privilege of limited liability do so with a proper sense of responsibility[175] and to protect the public against those whose past records as directors shows them to be a danger to creditors, employees and shareholders.[176] On the other hand, overly rigorous standards could inhibit the forming and expansion of new business ventures[177] and could constitute a substantial, and arguably unwarranted, interference with individuals who wish to be involved in the management of companies.[178]

In 1962, the Jenkins Committee recommended that incompetence should be a ground for unfitness.[179] However, when an opportunity for reform came in the Insolvency Act 1976, the government concluded that to permit disqualification on grounds of incompetence alone would go unwisely far. [180] S.9 Insolvency Act 1976 therefore permitted disqualification on the grounds of unfitness if an individual had been a director of at least two companies that had gone into insolvency within five years of each other. The view that disqualification *per se* could result in disqualification was also seen as being too harsh by the Cork Committee in 1982.[181]

However, an extreme proposal was put forward by the government in 1984,[182] and included in the Insolvency Bill 1985, under which every director of a company in compulsory liquidation would be disqualified unless he could disprove unfitness.

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174 DTI, *Companies in 1994-95*, 1995, London: DTI, p.39.
175 *Re Swift 736 Ltd.* [1993] BCC 312.
176 *Re Grayan Building Services Ltd.* [1995] BCC 554 at 577, *per* Henry LJ.
177 *Re Rolus Properties Ltd.* (1988) 4 BCC 446.
178 *Ibid.*
179 *Report of the Company Law Committee*, 1962, Cmnd. 1749, London: HMSO, para. 85(b).
180 On the background of the 1980's insolvency legislation, see I. Fletcher, *The Genesis of Modern Insolvency Law-An Odyssey of Law Reform* [1989] JBL 365.
181 *Report of the Review Committee on Insolvency Law and Practice*, 1982, Cmnd. 8558, London: HMSO, Ch. 45.
182 *A Revised Framework for Insolvency Law*, 1984, Cmnd. 9175, London: HMSO, Ch.2.

Understandably, this proposal attracted a wealth of criticism and once the Bill had been voted down twice by the House of Lords, it was withdraw and what is now s.6 CDDA 1986 was enacted instead. Accordingly, as statute gives no guidance, it is up to the courts to decide whether or not incompetence should form grounds for disqualification.

In determining this, the courts have concluded that mismanagement or incompetence are not *ipso facto* grounds for disqualification.[183] In Re Dawson Print Group Ltd.,[184] Hoffman J spoke of the need to find:

> some conduct in breach of standards of commercial morality or some gross incompetence which persuaded the court it would be a danger to the public if [the director] was allowed to continue to be involved in the affairs of companies. [185]

In Re Lo-Line Electric Motors Ltd.,[186] Browne-Wilkinson V-C, commenting on s.300 Companies Act 1985 stated:

> In the normal case, the conduct complained of must display a lack of commercial probity, although I have no doubt that in an extreme case of gross negligence or total incompetence, disqualification could be appropriate. [187]

Finally, in Re ECM (Europe) Electronics Ltd., the court in summing up, repeated the words of Peter Gibson J when it stated:

> To reach a finding of unfitness the court must be satisfied that the director has been guilty of a serious failure or serious failures, whether deliberately or through incompetence, to perform those duties of directors which are attentive in the privilege of trading, through companies with limited liability. [188]

It is apparent that whilst it is acknowledged that mismanagement *per se* is not grounds for disqualification, the courts are not entirely certain as to what constitutes unfitness. This is in part due to the confusion surrounding the ethos behind the provisions. There are two clearly opposed views. One is that the imposition of a disqualification order is a penal sanction designed to punish the director. The other is

[183] *E.g.* *Re Churchill Hotel (Plymouth) Ltd.* [1988] BCLC 341.
[184] [1987] BCLC 601.
[185] *Ibid.* at p.604.
[186] [1988] BCLC 698.
[187] *Ibid.* at p.703.
[188] *Ibid.*

that the director should be removed from office so as to protect the public, and most notably creditor interests.[189]

In the case of Re Sevenoaks Stationers (Retail) Ltd.,[190] Dillon LJ stated:

> It is beyond dispute that the purpose of section 6 is to protect the public, *and in particular potential creditors of companies*, from losing money through companies becoming insolvent when the directors of those companies are people unfit to be concerned in the management of a company. [191]

However, it is respectfully stated that the purpose of s.6 is not beyond dispute. There is judicial inconsistency in the application of this ethos as regards the disqualification of directors. An examination of three prominent cases will demonstrate this inconsistency.

The first case is *Re Ipcon Fashions Ltd*.[192] Over a period of nine years, the director in question, Mr. Hava, saw four of his companies become insolvent. The issue placed before the court concerned the last one. That company, Ipcon Fashions, was created in May 1985, but by July 1986 was obviously insolvent, [193] and so Mr. Hava decided to wind up the company. However, between deciding this and actually completing the winding up procedure (some four months) and despite owing significant PAYE and VAT sums, Mr. Hava, his wife and two other employees received weekly salaries. Hoffman J had no hesitation in finding Mr. Hava s conduct unfit and disqualified him for five years.

Doubtless, this is the correct decision. Mr. Hava s conduct of Ipcon coupled with his management of the other companies, the obvious exhibition of the Phoenix Syndrome and the extremely casual attitude to his duties [and his] want of probity in dealing with certain creditors as well as a reckless disregard of the interests of all

[189] In order to protect such parties, the names of directors who are currently the subject of disqualification orders can be found at http://www.companieshouse.gov.uk.
[190] [1991] Ch. 164.
[191] *Ibid.* at p.176 (italics added). See also *Re Stanford Services Ltd.* [1987] BCLC 607 at 620, where Vinelott J said (italics added):

> If it is shown that the respondent has been guilty of a serious breach of his obligations as a director, *and to have caused loss to the creditors of a company*, the public interest requires that the misconduct be recognized and reflected in an order of disqualification.

[192] (1989) 5 BCC 773.
[193] *Ibid.* at p.774, *per* Hoffman J: it must have been obvious to Mr. Hava that the company was insolvent.

creditors including in particular the Crown [194] all helped ensure that, despite there being no personal dishonesty, a disqualification order was inevitable.

Ipcon was couched in the language of protection. [195] Thus here, the purpose of the disqualification was said not to be penal but rather to protect the public against being ripped off [196] by the likes of Mr. Hava s use of limited liability. However, are the disqualification provisions *purely* protective *i.e.* is some element of blameworthiness required?

Some cases[197] have suggested that blameworthiness is an essential ingredient and in the second case for examination *Re CU Fittings Ltd.*,[198] blameworthiness was certainly present. Here, the director, Mr. Turton, had two companies become insolvent under his management. The first company, CU Fittings Ltd. went into voluntary liquidation in 1982 and another company, Packaging Ltd., took over the viable [199] side of the business. However, Packaging Ltd. made substantial losses and a principal supplier, a Canadian company by the name of Streamline, presented a winding up petition in June 1984. Prior to the winding up order, Streamline had made various promises of financial assistance to Packaging Ltd., all of which were unfulfilled. In court, it was submitted that Mr. Turton was unfit to be a director as he should have known that after January 1984, the company could not have been saved and he should have ceased trading then.

However, Hoffman J disagreed. He stated that:

> directors immersed in the day to day task of trying to keep their businesses afloat could not be expected to possess wholly dispassionate minds regarding the likely demise of their companies they cling to hope. [200]

Also Mr. Turton had quite properly relied on assurances from Streamline s representative that his company would not be allowed to sink. [201] Accordingly, he

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[194] *Ibid.* at p.775.
[195] V. Finch, *Disqualification of Directors: A Plea for Competence* (1990) 53 MLR 385 at 386.
[196] *Re Douglas Construction Services Ltd.* (1988) 4 BCC 553 at 557, *per* Harman J.
[197] *Re McNulty s Interchange Ltd.* (1988) 4 BCC 533 at 536, *per* Browne-Wilkinson V-C; *Re Lo-Line Electric Ltd.* [1988] BCLC 698 at 703, *per* Browne-Wilkinson V-C.
[198] (1989) 5 BCC 210.
[199] *Ibid.* at p.212. CU Fittings Ltd. dealt in copper tubes and fittings. Accountants advised the director that the fittings side of the business was still viable.
[200] *Ibid.* at p.213.

had not been gambling at the expense of his creditors on the possibility that something may turn up. [202]

Here, the court has moved away from a purely protective stance. In emphasizing the honesty of the director, the court implicitly stated that a lack of blameworthiness is a factor. In effect, the court will be sympathetic towards honest optimistic directors.[203] This is despite the fact that a disqualification order is in the public and creditor interest.

The final case is *Re Cladrose Ltd.*[204] and is apparently based on punitive principles alone. Here, the respondents were directors of three insolvent companies in all of which there had been a total failure to produce audited accounts and file annual returns. One director, Mr. Pollard, contended that he had relied on another director, Mr. Platt, a chartered accountant, and that Mr. Platt understood this. Mr. Pollard escaped disqualification. Mr. Platt, however, was disqualified for two years.

This was despite the fact that there was no personal misconduct, no dishonesty and the directors themselves had lost substantial sums. Further, Harman J concluded that there had been no negligence or incompetence, merely mismanagement. The question therefore rested on the failure to submit accounts.

As a chartered accountant, Mr. Platt could be expected by his fellow directors and the court to have a better knowledge and understanding of company law and of the formal duties to make returns than persons who do not hold that distinguished qualification. [205] Accordingly, Mr. Platt exhibited an unwarrantable disregard, an unwarrantable lightness of view, as to the seriousness of keeping the registrar informed. [206] Conversely, Mr. Pollard whilst not totally innocent may be very much less blameworthy if it can be said [that he] relied upon somebody whom they had

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[201] *Ibid.*
[202] *Ibid.*
[203] *Cf.* the sunshine test in *Re White & Osmond (Parkstone) Ltd.* (Ch.D. 1960) Unreported, 30th June 1960, *per* Buckley J.
[204] (1990) 6 BCC 11.
[205] *Ibid.* at p.14.
[206] *Ibid.* at p.19.

good and sufficient cause to believe was the proper person to rely on. [207] Thus Mr. Platt was disqualified even though there was no intention to deceive creditors or the public and even if the accounts were filed, they would not have protected the creditors.[208]

The fact that the court distinguished between the two directors demonstrates the move away from protective principles. Ultimately, both directors were under a duty to submit accounts and a protective regime would have demanded that they were both disqualified. Mr. Platt was singled out because he was blameworthy and was punished accordingly.

It is therefore apparent that whilst protective considerations are present, that is not to say that punitive principles are absent. Despite what the judiciary may say, the CDDA provisions are not purely protective. They are an amalgam of penal and protective measures. Occasionally, the courts have hinted at this:

> The primary purpose of the section is not to punish the individual but to protect the public against the future conduct of companies by persons whose past records as directors of insolvent companies have shown them to be a danger to creditors and others. Therefore, the power is not fundamentally penal. But, if the power to disqualify is exercised disqualification does involve a substantial interference with the freedom of the individual. It follows that the rights of the individual must be fully protected . [S]ince the making of a disqualification order involves penal consequences for the director, it is necessary that he should know the substance of the charges that he has to meet [209]

The Court of Appeal has now set out sentencing guidelines for disqualification orders which seem to indicate a close parallel between sentencing for unfitness and sentencing in the criminal courts.[210]

Even if the provisions are punitive, the public and creditors may be benefited as a by-product. In certain cases, the courts may take a more stringent, punitive line with directors, most notably where the company in question has substantial Crown debts.

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207 *Ibid.* at p.14.
208 *Ibid.*
209 *Lo-Line Electric Motors Ltd.* [1988] Ch. 477 at 486, *per* Browne-Wilkinson V-C.
210 *Re Sevenoaks Stationers* [1991] BCLC 325.

However, at first this was not the case. Indeed, the Cork Committee[211] recommended that private debts should have preference over community debts; a view that has to some extent influenced the list of preferential debts in Sch.6 Insolvency Act 1986, although PAYE, NIC and VAT still have preference. This view was shared by the court in *Re Dawson Print Group Ltd.*[212] where they held that the failure to pay certain Crown debts was not to be regarded as indicative of unfitness, holding that the Crown in appointing tax collectors run the risk of non-payment, a risk compensated by the preferential status which those debts enjoy. It is true that a bad debt owed to the State is likely to be a drop of water in the ocean, whereas loss of a similar sum to a private creditor might be catastrophic. [213]

However, this is not the present view. In *Re Stanford Services Ltd.*,[214] Vinelott J refused to follow *Dawson* in declining to take a lenient view of a company that continued to trade whilst owing large sums to the Crown. The court stated that the Crown was an involuntary creditor whereas trade creditors are voluntary creditors who can check up on the company or secure the loans via reservation of title clauses or fixed/floating charges.[215] This view has since been confirmed in *Re Churchill Hotel (Plymouth) Ltd. and Others*.[216]

What is clear, however, is that the need to protect creditors has been a constant theme in the disqualification cases to date and directors who take unwarranted risks with creditors money face the real risk of disqualification.[217] As Henry LJ stated in the case of *Secretary of State for Trade and Industry v Gray*:[218]

> The concept of limited liability and the sophistication of our corporate law offers great privileges and great opportunities for those who wish to trade under that regime. But the corporate environment carries with it the discipline that those who avail themselves of those privileges must accept the standards laid

[211] *The Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd. 8558.
[212] [1987] BCLC 601.
[213] C.D. Drake, *Disqualification of Directors-The Red Card* (1989) JBL 474 at 482.
[214] [1987] BCLC 607.
[215] See also *Re Sevenoaks Stationers Ltd.* [1991] Ch. 164.
[216] [1988] BCLC 341.
[217] See *Re Synthetic Technology Ltd., Secretary of State for Trade and Industry v Joiner* [1993] BCC 549; *Re Firedart Ltd., Official Receiver v Fairall* [1994] 2 BCLC 340; *Secretary of State for Trade and Industry v Gray* [1995] 1 BCLC 276; *Secretary of State for Trade and Industry v Laing* [1996] 2 BCLC 324; *Secretary of State for Trade and Industry v McTighe (No. 2)* [1996] 2 BCLC 477; *Re Richborough Furniture Ltd.* [1996] 1 BCLC 507; *Secretary for State and Industry v Lubrami, Re Amaron Ltd.* [1997] 1 BCLC 115.
[218] [1995] 1 BCLC 276.

> down and abide by the regulatory rules and disciplines in place to protect creditors and shareholders . The Parliamentary intention to improve managerial safeguards and standards for the long term good of employees, creditors and investors is clear. [219]

The second issue we will discuss relates to sanctions. One possible reason for the requirement of blameworthiness is the mandatory nature of the sanction. S.6(4) CDDA reads:

> 6(4) Under this section the minimum period of disqualification is 2 years, and the maximum period is 15 years.

Unlike s.300 Companies Act 1985, there is no discretion as to sentencing. If the director is to be disqualified, he will be disqualified for a minimum of two years.[220] Conversely, if the court feels that disqualification is too harsh, it is forced to avoid finding unfitness altogether. It is this lack of flexibility that concerns commentators.[221]

The mandatory nature of the Act creates significant difficulties for the courts. The whole rationale for forming a limited liability company is to allow and encourage entrepreneurial risk-taking. Draconian penalties such as those found in the CDDA will defeat this objective by making management excessively defensive.[222] When this is coupled with the fear of a wrongful trading action as the company nears insolvency, this fear becomes even more pronounced.

As one commentator has correctly noted [e]ven the most draconian laws against delinquent directors will be a dead letter if enforcement is defective. [223] Enforcement is probably the CDDA s largest flaw. Initially, the signs were encouraging with an impressive annual growth of disqualifications:

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[219] *Ibid.* at p.288.

[220] However, it should be noted that the mandatory nature is to an extent mitigated by the ability of the court to permit a disqualified director to act as a director during the period of disqualification. S.1 defines a disqualification order as an order that [the defendant] shall not, without the leave of the court be a director Such an order was made in the case of *Re Majestic Recording Studios* [1989] BCLC 1, where the judge made a clear finding of unfitness but allowed the director to continue to be a director because of the hardship that it would cause to the employees where he to be fully disqualified.

[221] See *e.g.* K.T.W. Ong, *Disqualification of Directors: A Faulty Regime?* (1998) 19 Co.Law. 7 at 9; C.D. Drake, *Disqualification of Directors: The Red Card* (1989) JBL 474 at 479.

[222] *Ibid.*

[223] C.D. Drake, *Disqualification of Directors: The Red Card* (1989) JBL 474 at 485.

Table 4.1: CDDA Disqualifications 1986-89.[224]

Year	Applications	Disqualifications
1986	22	18
1987	180	81
1988	421	204

However, it soon became apparent that the enforcement agencies were unable to cope with this increase in applications. Evidence came from the National Audit Office in their 1993 report.[225] Between 1986-93, there were just under 40,000 corporate insolvencies, yet disqualification proceedings were only brought against 1,712 directors.[226] The NAO found similar shortcomings. Between 1987 and 1993, disqualification proceedings were commenced on 2,900 occasions, with just over 1,700 disqualification orders being made. Despite this, many cases deserving of investigation were not pursued. The NAO s study found that among the 153,000 corporate insolvencies during the period 1987-1993, 28,500 involved unfit conduct and 4,300 involved serious public interest breaches. Further, even where there is a disqualification order made, enforcement is piecemeal. The NAO report found that Companies House had failed to maintain an up-to-date list of disqualified directors and that insufficient effort was made to ensure that disqualified directors left their directorships and did not take up new ones.[227] Given the above, it is not surprising that the NAO found that the CDDA had not had a significant deterrent effect of company directors. Of the directors questioned, nearly 60% were unaware of the existence of the CDDA and 57% said that they were not well informed about disqualification procedures.[228]

There is evidence to indicate that the situation is improving. In 1999, the NAO issued a follow-up report to its 1993 report.[229] It revealed that in 1997-8, there were over 1,400 disqualification proceedings compared to 600 in 1992-3. The number of s.6

[224] *Ibid.* at p.486.
[225] National Audit Office, *The Insolvency Service Executive Agency: Company Director Disqualification*, 1993, London: NAO.
[226] T. Pryce-Brown, *Efficient Disqualification: Auditor s General Report on the Insolvency service Executive Agency: Company Directors Disqualification* (1994) IBFL 16 at 16.
[227] National Audit Office, *The Insolvency Service Executive Agency: Company Director Disqualification*, 1993, London: NAO, p.19. On the obligations of the DTI and Companies House, see s.18 CDDA 1986.
[228] *Ibid.* at p.16.
[229] National Audit Office, *Company Director Disqualification — A Follow Up Report* 1999, London: NAO.

proceedings has risen from 399 in 1992-3 to 1,267 in 1997-8. The DTI notes another rise in 2000-2 to 1,548.[230] The Insolvency Service now contends that it proceeds with all cases it believes are in the public interest. The 1993 report criticised the Insolvency Service for failing to adequately assess the resources it would need to pursue sufficient disqualifications. The follow-up report now notes that expenditure on disqualification has increased from £9 millions in 1992-3 to £22 millions in 1997-8.[231] The NAO further states that disqualification as a proportion of the overall expenditure has increased from 11% to 28% in 1997-8.

As a result of the above improvements, the NAO report states that s.6 disqualifications save creditors £11 million per year. However, whilst this figure may seem initially impressive, there are two reasons why this is not so. First, £11 million, spread across a million or so public companies and a few million or more unincorporated businesses, looks like a small amount.[232] Second, this £11 million saving to creditors came at a cost of £22 million to the taxpayer.[233] It has also been argued that rather than saving creditors money, the disqualification system can force costs upon the creditors.[234] When a company is liquidated, the office-holder in charge[235] must file a report with the Insolvency Executive Agency if it appears that a director is unfit.[236] If the matter merits pursuing, the office-holder will then have to co-ordinate his efforts with the Agency staff responsible for disqualification. Since the office-holder s expenses are payable out of the company s assets in priority to all other claims,[237] these costs are borne by the company s creditors.[238] The creditors may resent this since they receive no direct benefit from the disqualification order.

Put simply, there is still a strong presumption that the Act has little or no deterrent value and that disqualification does little to protect creditor interests. It appears that

[230] DTI, *Companies in 2001-2002*, 2002, London: DTI, p.38.
[231] National Audit Office, *Company Director Disqualification — A Follow Up Report* 1999, London: NAO, para.1.14.
[232] A. Hicks, *Director Disqualification — the National Audit Office Follows Up*(1999) 15 Insolv. L. & Prac. 112 at 115.
[233] *Ibid.*
[234] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.552.
[235] An official receiver in the case of a compulsory liquidation and an insolvency practitioner if it is a voluntary liquidation.
[236] S.7(3) CDDA 1986.
[237] S.115 Insolvency Act 1986.

the problem lies, not with the law, but with the enforcement of the law. As one commentator has stated [w]hile some of that may be faults in the Act, a major part of it must also be the way in which the Act is being implemented. [239] Despite the NAO s 1999 follow-up report, this presumption still exists.

The procedural and resource problems highlighted above were of significant concern to warrant reform, namely the Insolvency Act 2000. The new Act introduced what has been termed a fast-track [240] method of disqualification under which the Secretary of State is able to accept an undertaking from a director that they will not act as a director for a period between two and fifteen years.[241]

This fast-track procedure is not strictly new since a similar arrangement was available before the 2000 reforms. This arrangement was known as a Carecraft disposal following the case of *Re Carecraft Construction Co. Ltd.*[242] This would basically involve both parties reaching an agreement as to the appropriate period of disqualification and, if the director agrees, then the disqualification case can be dealt with by the court in a summary fashion. The following year, the Vice-Chancellor of the Chancery Division recommended to the Secretary of State that he give serious consideration to either introducing or amending legislation to permit such undertakings and to grant them the same effect as a court order imposing a disqualification period.[243] There is little doubt that the motivating factor behind this recommendation was the need to cut costs and the workload on the Insolvency Service in relation to disqualification orders. Following the new Act, as from the 2nd April 2001, these undertakings now have the same force as a court order.

The effect of this new procedure has been evident. The DTI reports that in 2000-1, there were 1,548 disqualification orders under s.6.[244] In 2001-2, there were only 548.[245] This substantial reduction is no doubt due to the new procedure. However,

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238 R.M. Goode, *Principles of Corporate Insolvency Law*, 1990, London: Sweet & Maxwell, p.71.
239 Alan Williams, a member of the Public Accounts Committee quoted in A. Hicks, *Director Disqualification — the National Audit Office Follows Up*(1999) 15 Insolv. L. & Prac. 112 at 118.
240 A. Walters, *Directors Disqualification After the Insolvency Act 2000* (2001) 3 Insolv. L. 86 at 86.
241 S.1A Directors Disqualification Act 1986, inserted by s.6 Insolvency Act 2000.
242 [1994] 1 WLR 174, approved in *Secretary of State v Rogers* [1996] 1 WLR 1569.
243 See *Practice Note* [1996] 1 All ER. 442.
244 DTI, *Companies in 2001-2002*, 2002, London: DTI, p.38.
245 *Ibid.*

these figures do not tell us how many undertakings there were. Thankfully, these figures are available from the NAO, who note that in 2001-2, there were 1,213 undertakings pursuant to s.1A resulting in an overall increase in disqualification orders of 13.8%.

There is therefore little doubt that the 2000 reforms will benefit the Insolvency Service and should allow them to focus their efforts. However, there is the danger that the new procedure may serve to undermine the protective objectives of the CDDA. We have seen that one of the aims of the CDDA was to act as a deterrent. The ability to agree an undertaking, although doubtless cost-effective, may be viewed as a soft option, allowing a director to avoid the stigma and embarrassment of formal proceedings. This was discussed in the recent case of *Re Blackspur Group plc.: Secretary of State for Trade and Industry v Eastaway*.[246] Here, the defendant director wished to accept a period stated in an undertaking. However, he did not want the reasons for disqualification attached to the undertaking document fearing that this could affect his future career prospects. At first instance, Potter J dismissed the undertaking application holding that the Secretary of State was able to reject an undertaking that did not have such information attached. The Court of Appeal upheld the decision stating that the Secretary of State not only had the power to accept the undertaking, he also had the power to reject the content.

This decision is to be applauded. To have permitted the director to agree an undertaking but without stating the reasons for disqualification would have adversely affected the deterrent effect of the disqualification procedure.[247] In addition, it would prevent the public from knowing the reasons for disqualification.

Conclusion.

A leading academic has clamed that the above developments in relation to creditors have greatly altered the topography of company law [and constitute] unquestionably one of the most important developments in company law this century. [248] Analysis of

[246] [2001] EWCA Civ. 1595, LTL 13/9/2001.
[247] A. Walters, *Bare Undertakings in Disqualification Proceedings: A Postscript* (2002) 23 Co. Law. 123.
[248] D.D. Prentice, *Creditor s Interests and Director s Duties* (1990) 10 OJLS. 265 at 277.

the various developments relating to the protection of creditors has shown them not to be as radical as some academics first thought. The duty of directors towards creditors is still extremely vague in its application, and there are commentators who believe that it is still not well enough established to alter the traditional beneficiaries of the *bona fide* duty, namely the shareholders. It comes into effect at too late a stage ensuring that as long as the company remains on the right side of doubtful solvency, they need not consider the interests of creditors.[249] S.214, first thought by many to be a highly effective means of creditor protection, has shown itself to be highly problematic in practice with the result that it has had little impact. Despite this, there are still commentators who have argued that s.214 is all the protection that creditors need and that it provides them with ample protection.[250] The provisions in the CDDA are inadequately enforced and provide only a weak incentive.

If company law is genuinely concerned about the position of creditors, then stronger and more effective measures need to be taken. The Company Law Review Steering Group has considered the possibility that its statutory statement of directors duties should incorporate the s.214 test into the general duty as it currently stands.[251] This might provide slightly more clarity in terms of determining when the duty has been breached and give directors more indication of when they should act. However, many of the aforementioned problems would remain. Their suggestion that the duty should come into effect at an earlier stage (when there is a substantial probability of insolvency) is one to be welcomed.[252] However, they were unable to reach a consensus on this issue in the available time and so did not overtly recommend it, but rather advised further consultation.[253] As we saw, the Government has since decided not to incorporate s.214 into the statutory statement of directors duties.

Given this, one cannot help but feel that the protection offered to creditors has been relatively ineffective. The great changes envisaged by many academics at the end of the 1980 s have not materialised. The creditor developments have done little to alter the legal model of the company. Until the company becomes doubtfully solvent, the

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[249] N. Hawke, *Creditors Interests in Solvent and Insolvent Companies* (1989) JBL 54 at 60.
[250] Se *e.g.* L.S. Sealy, *Directors Duties — An Unnecessary Gloss* (1988) CLJ 175 at 177.
[251] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, 2001, London: DTI, para. 3.16.
[252] *Ibid.* at para. 3.17.

directors are still obliged to act in the interests of their members.[254] S.214 only comes into effect once the company is insolvent and due to practical issues, namely the issue of funding, wrongful trading claims are extremely rare. The conclusion must therefore be that whilst there are legitimate reasons to protect the creditors, the law has not changed sufficiently to achieve this.

III. INDUSTRIAL DEMOCRACY AND EMPLOYEE PROTECTION

The Evolution of Employee Protection: 1870-1980.

Under early company law, a company s employees were perceived as having no legitimate interest in the business or its assets, and were therefore offered no protection. Employees could benefit from managerial acts, but only where this benefit coincided with the shareholders.[255] This dismissive approach toward employees was reflected in the *ultra vires* rule during this period. For example, in *Hutton v West Cork Railway Co.*,[256] the Court of Appeal stated that it was beyond the company s objects to make gratuitous payments to past or present employees.

The first breakthrough regarding employee protection came towards the end of the nineteenth century with the advent of the preferential rights regime. Employees were given protection in the event of corporate insolvency in respect of a certain proportion of arrears of salary. These arrears were to be treated as preferential debts ranking ahead of the claims of floating charge holders. This was effected by the Preferential Payments in Bankruptcy Act 1888.

The question we must now ask is what was the reason behind this change in social policy. At the time of the creation of the preferential rights regime, employee wages were relatively low and would therefore not represent a major drain on the insolvent company s assets. Another important point to note is the fact that employees were not the only beneficiaries of this change in policy; local authorities owed rates and

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[253] *Ibid.* at para. 3.20.
[254] Due to s.309 Companies Act 1985, the employees also factor. However, as we shall see, this protection is highly ineffective and in practice, gives the employees little, if any, protection.
[255] See *Hampson v Price s Patent Candle Co.* (1876) 45 LJ. Ch. 437, where the court said that keeping the workforce happy was a prudent objective, but was not a legal requirement.
[256] (1883) 23 Ch.D. 654.

government departments having claims in respect to unpaid tax also gained preferential status.

The employee s preferential status escaped the cuts advocated by the Cork Committee in 1982[257] and still survive in Schedule 6 of the Insolvency Act 1986. The Cork Report recommended abolishing preferential rights for employees and instead protecting them through the state guarantee system, which is discussed shortly.

This policy of protecting employee interests though a preferential priority mechanism is one that has been adopted in most common law jurisdictions. It still survives in many countries today[258] despite a general cutback in preferential claims in general. Other countries, such as Canada,[259] prefer to protect employee interests by making directors personally liable for salary arrears on insolvency.

As was mentioned, our preferential payment regime was further strengthened by the introduction of the state guarantee system. Private law relief has now been replaced by public law support, due largely to the delays experienced by employees waiting for distribution out of the company s assets.[260] Under s.122 of the Employment Protection (Consolidation) Act 1978 the state guarantees that certain employee claims up to a specified limit will be met in full and where this is unlikely to happen because the employer is insolvent, the state will recompense the employee and then seek to be subrogated to the employees rights on corporate insolvency.

However welcome these developments were, they were only of aid once the company was insolvent. Employee protection during solvency was longer in coming. For many years, the courts upheld the principle that whilst the company was solvent, the directors were not obliged to consider the interests of employees. The American case of Dodge v Ford Motor Company[261] is illustrative of the approach adopted here. The directors of the Ford Motor Company decided to restrict dividends in order to

[257] *Report of the Company Law Committee*, 1962, Cmnd. 1749, London: HMSO, para.1450.
[258] *E.g.* s.556 Australian Corporations Law.
[259] S.1119 Canadian Business Corporations Act.
[260] D. Milman, *From Servant to Stakeholder: Protecting the Employee Interest in Company Law* in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyds of London Press, p.152.
[261] 170 NW. 668 (1919).

subsidise the price of cars manufactured by the company in the hope that this would stimulate the economy and secure the jobs of company employees. The court held that this was unlawful as it was not in the interests of the company s shareholders. Nearly 50 yeas later, the English courts in *Parke v Daily News Ltd*.[262] similarly held that it was *ultra vires* to advance the interests of employees at the expense of the shareholders.

However, this approach came under criticism during the 1970s. In the Canadian case of Teck Corporation v Millar,[263] Berger J stated [i]f today the directors of a company were to consider the interests of its employees no one would argue that in doing so that they were not acting bona fide in the interests of the company itself. [264] Similar criticisms surfaced in the UK at a governmental level. The Bullock Committee on Industrial Democracy called for a statutory reversal of the common law rule. A subsequent Government White Paper on the Conduct of Company Directors made a similar proposal. These proposals eventually made their way into proposed legislation in the Companies Bills of 1973 and 1978. However, neither of these were successfully introduced. Eventually, such a proposal did make it onto the statute books in the form of s.46 Companies Act 1980, which is now s.309 Companies Act 1985 and it is this provision that we now examine.

S.309 Companies Act 1985.

Prior to 1985, British company law was governed by no less that eight statutes spanning forty years.[265] A major consolidation of our company law was in order, and this came in the form of the Companies Act 1985 and three supplementary Acts.[266] S.46 Companies Act 1980 became s.309 Companies Act 1985, and this is the main company law provision concerning employee governance protection. It is also to date, the only piece of legislation identifiable with stakeholder theory. In examining s.309, two issues will be examined: the content of the duty and the issue of enforcement.

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262 [1962] Ch. 927 discussed *infra*.
263 [1973] 33 DLR (3d) 288.
264 *Ibid*. at p.314.
265 These were the Companies Acts 1948, 1967, 1976, 1980, 1981 and 1983, the European Communities Act 1972 and the Companies (Floating Charges and Receivers) (Scotland) Act 1972.

S.309(1) which concerns the content of the duty provides that:

> 309(1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company s employees, as well as the interests of its members.

The question that preoccupies us here is to what extent, if any, does s.309 deviate from the legal model. This question has proved to be extremely difficult to answer as there are at least two polarized interpretations of the phrase have regard; one being overly conservative, the other overly ambitious. In other words, one leaves the legal model unaltered, the other renders it obsolete.

The more ambitious interpretation holds that the shareholders and employees are to be given equal ranking by the directors,[267] as is the case with the Draft Fifth Directive.[268] This view would render the legal model obsolete as the interests of the company would cease to be shareholder exclusive and would also encompass employees. The more conservative view contends that s.309 merely requires that directors *consider* the interests of the employees.[269] According to this view, the legal model would be relatively unaltered as the shareholders would still be the primary recipients of the directors attentions with the employees having a subordinate claim.[270]

Although it is acknowledged that the more conservative approach is the intended one,[271] it is unclear which of the two interpretations the courts favour. There is surprisingly, some evidence to suggest that the court has favoured the more ambitious

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[266] The Companies Securities (Insider Dealing) Act 1985, the Business Names Act 1985 and the Companies Consolidation (Consequential Provisions) Act 1985.

[267] V. Joffe, *The Companies Act 1980 - A Practical Guide*, 1980, London: Oyez, para.12.103; Lord Wedderburn, *Derivative Actions and Foss v Harbottle* (1981) 44 MLR 202 at 208.

[268] Arts. 10(a) and 21(q) Amended Fifth Company Law Directive.

[269] J. Birds, *Making Directors Do Their Duties* (1980) 1 Co. Law. 67 at 72.

[270] A.J. Boyle, *Gore-Brown on Companies*, 1986, 44th ed., Bristol: Jordans, paras.27.4 and 27.4.1. This was the view put forward by ministerial statement in Hansard:

> We start from the proposition that the directors duty to the company is to carry out their functions in what they consider to be the interests of the company as a whole. Subsection (1) of new clause 20 [what was to be s.46 Companies Act 1980] does not seek to change this and therefore means that the directors, as a matter of obligation, shall continue to have regard to the interests of the shareholders, present and future, in the course of carrying out their functions.

1979 Parl. Deb., HoC Official Reports, Standing Committee A, Companies Bill (Lords), col. 360 (statement of Cecil Parkinson, Minister for Trade).

[271] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework*, February 1999, London: HMSO, para.5.1.21.

approach. In *Re Welfab Engineers Ltd.*,[272] the company s liquidator alleged that the company s directors, faced with insolvency, had improperly sold the company for less than its full value. Hoffman J held the company not liable because the purchaser was prepared to take on the company s existing workforce, whereas a higher offer may have resulted in the redundancies of the company s employees. Even if there was a breach of duty, Hoffman J indicated that relief for the directors would have been available under s.727 Companies Act 1985 because they had acted honestly, reasonably and ought fairly to be excused.

The clearest indication to date came in the case of *Fulham Football Club Ltd. v Cabra Estates plc*.[273] Here, the plaintiff company, Bannerton Ltd., agreed that, in return for substantial payments, its football club, Fulham, would stop using its home ground so that a subsidiary of the defendant company could redevelop the ground. The directors of the plaintiff company, which had by now renamed itself Fulham Football Club Ltd., also covenanted not to oppose planning permission for the redevelopment. Subsequently, they decided that the redevelopment would not be in the best interests of the club, and sought to rely on this fact and the fact that the directors of Fulham Football Club Ltd. had, in agreeing not to oppose planning permission, unlawfully fettered their discretion.[274] The Court of Appeal rejected this argument, and went on to hold that even if the directors had acted improperly, it would have made no difference if the agreement had the unanimous assent of the shareholders. The court held that:

> the company is more than just the sum total of its members. Creditors, both present and potential, are interested, while section 309 of the Companies Act 1985 imposes a specific duty on directors to have regard to the company s employees in general. [275]

However, despite this, it is still unlikely that this section will have much of an impact on management behavior for two reasons.

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[272] [1990] BCLC 833. See also *Re a Company, ex. p. Burr* [1992] BCLC 724, a case that concerned the acquisition of a new company premises. Vinelott J held that in deciding whether or not to acquire the premises, the directors were entitled to take into account the interests of the employees.

[273] [1992] BCC 863.

[274] In *Kregor v Hollins* (1913) 109 LT 225, it was established that a director may not fetter his discretion by contract with an outsider. See also *Thorby v Goldberg* (1964) 112 CLR 597.

[275] [1992] BCC 863 at 876, *per* Neill LJ.

The first reason is that the relevant duty is akin to the *bona fide* duty in that it is a subjective one.[276] Accordingly, as s.309 gives no guidance as to the weighting of the interests, the matter must be decided by the directors. What this means is that no breach of s.309 will occur simply because the directors have honestly mis-weighted those interests. In effect, s.309 is subject to the business judgment rule.[277] Accordingly, any act that is detrimental to the employees will only be a breach of s.309 if the directors lacked good faith. In practice, these cases are likely to be very rare as such an act can be in some way justified by reference to the employees or shareholders. For example, substantial job cuts in one factory may secure the jobs of employees in other factories, or may be viewed as streamlining with a view to increasing profits.

The second problem and indeed the second issue to be discussed relates to enforcement. S.309(2) provides that:

> 309(2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.

In other words, as the duty is owed to the company, the company can be the only plaintiff in a case concerning a breach of s.309. However, the right to commence proceedings for wrongs done to the company is vested solely in the directors leading to the possible situation of the directors in the form of the company being the plaintiffs, and the same directors being the defendants. Clearly such a situation is not going to happen. Accordingly, the only other way for a s.309 case to reach the court is via a shareholder derivative action.[278] An employee who is also a shareholder could theoretically bring an action. However, derivative actions are notoriously difficult to launch with prospective plaintiffs having to wade through 140 years accumulation of

[276] This is in contrast to France and Italy where the company s interests (*l int r t social* or *l interesse sociale* respectively) have a more objective interpretation. For example, in Italy, the shareholders right to vote is more limited that it is in the UK. Article 2373 prohibits shareholders from voting where their interests conflict with the company s. Germany has gone one step further and advocated the enterprise interest (*Unternehmensinteresse*.) For more, see P. Xuereb in P. Xuereb and R. Drury (eds.), *European Company Laws: A Comparative Approach*, 1991, Aldershot: Dartmouth, pp.145-54.

[277] Again it is worth stressing that whilst the English courts have not accepted the business judgment rule in name, they have accepted it in principle. See *Shuttleworth v Cox Bros. & Co. (Maidenhead) Ltd.* [1927] 2 KB 9.

[278] Lord Wedderburn, *Companies and Employees: Common Law or Social Dimension* (1993) 109 LQR 220 at 236: It is as though the legislature expected shop stewards to come to work with a share certificate in one hand and the exceptions to the rule in *Foss v Harbottle* in the other.

procedural codswallop. [279] Accordingly, a derivative action will be unlikely to succeed.

Normally when creating a statutory right, Parliament obeys the principle of *ubi jus ibi remedium.*[280] In the case of s.309, not only have the employees not been given a remedy, but there appears to be no workable remedy. It would be na ve to put this down to poor drafting as the problems faced by s.309 were readily foreseeable, particularly the problems of enforcement. Instead, it may be the case that the section was made purposely impotent.[281] In the 70 s and 80 s, corporate social responsibility was in effect industrial democracy. There was tremendous pressure on government in the shape of amongst others, the Bullock Committee,[282] to grant employees some protection within company law. However, even today, more than 20 years after the original provision,[283] the introduction of non-shareholder constituents into the company law framework is still very cautious. Accordingly, s.309 could be viewed as a means of satisfying the reformists whilst at the same time bringing about very little real change. For this reason, one commentator has described s.309 as little more than a public relations exercise. [284]

These failings mean that s.309 does little to augment directorial accountability. In fact, one could even take the cynical view that the section s true significance is to grant directors even more freedom. As s.309 does not impose the mandatory consideration of employee interests, it grants directors a *discretion* to deviate from the profit goal, so long as the employees benefit. The directors in Parke v Daily News[285] that were made to account in 1962, would not be held so accountable today.

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[279] L.S. Sealy, *Foss v Harbottle: A Marathon Where Nobody Wins* (1981) 40 CLJ 29 at 31.
[280] *Trans.:* When there is a legally recognized right there is also a remedy.
[281] J. Birds, *Making Directors Do Their Duties* (1980) 1 Co. Law. 67 at 73 upholds this view by describing the 1980 provision as window dressing. J.H. Farrar & B.M. Hannigan, *Farrar s Company Law*, 1998, 4th ed., London: Butterworths, p. 386 describe s.309 as a statutory provision without teeth.
[282] *The Report of the Committee of Inquiry on Industrial Democracy*, 1977, Cmnd. 6706.
[283] S.46 Companies Act 1980.
[284] D. Milman, *From Servant to Stakeholder: Protecting the Employee Interest in Company Law* in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyds of London Press, p.157.
[285] [1962] Ch. 927.

There can be little doubt that s.309 is unhappily drafted. [286] The damming criticism offered by Sealy is typical: The emptiness of the UK s section 309 is thus exposed. It is either one of the most incompetent or one of the most cynical pieces of drafting on record. [287] Despite this, s.309 has served as a model for reform in other common law jurisdictions. An almost identical provision was introduced into Irish company law by s.52 Companies Act 1990. A similar reform was also proposed by Australia s Cooney Committee in 1989.

The unexpected conclusion regarding s.309 is that it is not as ineffective as widely believed. In a minority of cases, it has been of real influence. However, this has been due to the courts willingness to embrace the spirit behind the provision rather than the actual words. In any case, it is unlikely that decisions such as those mentioned above will ever become the norm due to the limitations inherent to s.309. As Parkinson stated:

> An ambiguously worded provision, patently lacking adequate means of enforcement, may be too slender a ground on which to anticipate that the courts would sanction a derogation from the ownership rights of the shareholders [288]

Given the above failings, it was widely anticipated that s.309 would be repealed. The Company Law Review Steering Group has now confirmed this describing s.309 as neither desirable nor politically sustainable. [289] S.309 does not give the company enough power to subordinate the interests of shareholders. The only true situation in which the directors can subordinate the interests of shareholders to that of the employees is in relation to *ex gratia* payments to employees on cessation or transfer of the business. Accordingly, this provision will now be examined.

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[286] D. Milman, *From Servant to Stakeholder: Protecting the Employee Interest in Company Law* in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyds of London Press, p.158.

[287] L.S. Sealy, *Directors Wider Responsibilities - Problems Conceptual, Practical and Procedural* (1987-8) 13 Mon.L.R. 164 at 177.

[288] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.86.

[289] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, November 2000, London: DTI, para.3.5.

S.719 Companies Act 1985.[290]

In 1962, a moribund company, Daily News Ltd., proposed to devote the whole of the monies received from the sale of its newspaper business to employees displaced by the sale.[291] One shareholder disagreed with the payment and brought a derivative action in an attempt to halt the payment. In allowing the action, the court stated that the directors were giving the company s money:

> to its former employees to benefit those employees rather than the company prompted by motives, which, however, laudable and however enlightened from the point of view of industrial relations, were such as the law does not recognise as a sufficient justification. [292]

In time, it was thought that such a position was too harsh and so s.719[293] came in to being. Ss.719(1) provides that:

> 719(1) The powers of a company include power to make the following provision for the benefit of persons employed or formerly employed by the company or any of its subsidiaries, that is to say, provision in connection with the cessation or the transfer to any person of the whole or part of the undertaking of the company or that subsidiary.

This provision is important because it actually permits directors to prioritize the interests of employees. As this power is exercisable notwithstanding that the payment is not in the best interests of the company,[294] it specifically overrules Parke for the reason that as the company is moribund, the future flow of profits is no longer a concern.[295] An ordinary majority from the shareholders is required unless the articles provide the board to sanction payments without shareholder consent.[296]

However, although *prima facie* s.719 overturns the legal model, a closer examination reveals that this is not the case. Firstly, the legal model is maintained by the requirement for shareholder consent and second, any payment under s.719 has to be made out of distributable profits. Accordingly any payment under s.719 will be decided upon by the shareholders and paid out of profits that would have gone to the

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290 See also s.122 Employment Protection (Consolidation) Act 1978.
291 Parke v Daily News Ltd. [1962] Ch. 927. See Lord Wedderburn, *Ultra Vires and Redundancy* (1962) CLJ 141.
292 *Ibid.* at p.963, *per* Plowman J.
293 Formerly s.74(1) Companies Act 1980. See also s.187 Insolvency Act 1986.
294 S.719(2) Companies Act 1985.
295 J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.87.
296 S.719(3) Companies Act 1985.

shareholders in the form of dividends. Accordingly, s.719 is an affirmation of the legal model although it benefits a non-shareholder constituent.

Codetermination and European Works Councils.

As we shall see in Chapter 7, game theory states that even though consultation with workers will result in increased efficiency, there exist incentives which ensure that such co-operation does not take place. Game theorists therefore argue that governmental regulation is needed to ensure that both companies and workers co-operate to ensure joint wealth maximisation.[297] On the continent, such regulation has been in place for a number of years, most notably the German system of *Mitbestimmung* (codetermination)[298] in which employees play a significant role in company affairs. A central element of this system concerns the Works Constitution Act 1972. It applies to all but the smallest companies and requires co-operation between management and employees towards the aim of creating works councils. Management is required to consult the works council in relation to workplace issues (*e.g.* hours, overtime, health and safety) as well as major issues such as plant closures. Although management is under no obligation to reach an agreement with the works council, there is considerable pressure placed on executives to secure a mutually acceptable outcome before proceeding with any redundancies.[299]

The above suggests that Germany s codetermination system has helped managers and employees reach mutually beneficial outcomes. The evidence supporting this is compelling. Since World War II, the country has enjoyed significant economic success and German employees are amongst the highest paid in the world. Many commentators attribute this to the above measures.[300] Certainly it appears that this ethic of employee protection runs throughout the company. As the chairman of Siemens, a large German electronics group, stated codetermination means that we create a relationship of trust, that one talks to the people, that one tells the truth, that

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[297] M.A. O Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation* (1993) 78 Cornell LR. 899 at 936-40.

[298] For an overview of the system, see M. Weiss, *Germany* (1992) 23 Bull. of Compar. Lab. Rel. 107.

[299] G. Roder, *Labor Law Implications of the Restructuring of Enterprises in the Federal Republic of Germany* (1994) 28 Int. Lawyer 331 at 336-7.

[300] See *e.g.* R.J. Adams, *The Right to Participate* (1992) 5 Employee Resp. and Rts. J. 91 at 94 and K. Thelen, *Union of Parts: Labor Politics in Postwar Germany*, 1991, Ithaca, New York: Cornell University Press, pp.1-5.

one builds up a reserve of trust, not only if you are in difficulties, but over a long time. [301]

The apparent benefits of codetermination and employee participation have resulted in the German model achieving considerable popularity in UK political circles. In 1993, the Labour Party argued that the UK could benefit greatly if the law required that British companies have employee directors.[302]

UK law has now moved a step closer to wards the German system following a 1994 European Union Directive.[303] The Directive came into force on the 22nd December 1996, yet national implementation was slow. Only six countries managed to implement it before the September 1996 deadline — Belgium, Denmark, Finland, Ireland, Norway and Sweden. The Directive requires participating countries to set up works councils along the lines of those seen in Germany. When the Directive was first introduced, the UK was not bound to apply by its terms due to our infamous opt-out of the Social Chapter of the Maastricht Treaty. However, even though the UK was not bound to integrate the Directive into our national law, many companies still had to abide by its provisions. This is so because UK companies may have a significant proportion of their workforce based in countries that are subject to the Directive. As early as July 1994, two months before the Directive was passed, the TUC had identified 102 companies that fell into this category.[304] Other companies decided to implement EWCs on a voluntary basis having works councils in place well before the Directive came into force. However, one commentator has stated that qualitative and case study work on these works councils has revealed that very few of them have progressed far from being glorified information bureaux. [305]

[301] *Germany Needs its Works Councils* (1996) *Financial Times* 16th February.
[302] See *Making Britain s Future*, 1993, London: Labour Party, pp.5-6.
[303] Directive 94/45, *Directive on Establishment of a European Works Council*, OJ 1994 L254/64.
[304] See *Unions Central to Works Councils* (1996) 85(9) Labour Research 17 at 17. However, research carried out at the University of Warwick put this number in excess of 300: see P. Marginson, *The Coverage on United Kingdom Owned Companies by the European Works Council Directive*, 1996, Warwick Papers in Industrial Relations. These included *inter alia* United Biscuits, the NatWest Group, BT, Pilkingtons, GKN, ICI, Coats Viyella, IBM and Burger King
[305] P. Cressey, *Transnational Works Councils and Macro European Developments* in R. Markey and J. Monat (eds.), *Innovation and Employee Participation Through Works Councils: International Case Studies*, 1997, Aldershot: Avebury, p.42.

In 1997, however, the Labour Government agreed to join the Social Chapter and so was required to make the Directive part of our national law. This occurred on January 15th 2000 with the passing of the Transnational Information and Consultation of Employees Regulations.[306]

This means that all UK companies coming within the ambit of the Directive will be required to set up works councils. Companies qualifying are termed either Community-scale undertakings (CSU) or Community-scale groups of undertakings (CSGU.) A CSU is any firm with at least 1000 employees within the Member States and at least 150 employees in each of at least two of the Member States.[307] A CSGU is defined as a group of undertakings with (i) at least 1000 employees within the Member States, and (ii) at least two group undertakings in different Member States with at least 150 employees each.[308] Prior to the opt-in, employees in the UK were excluded.

These firms must, by way of European Works Council (EWC) or a satisfactory alternative procedure, consult with employees on cross-border decisions which affect the workforce. An enterprise s EWC will be composed of representatives from each Member State in which the company has an establishment with more than 150 employees. These representatives are to meet at least once a year, at the company s expense, with the enterprise s central management. [309] At this annual meeting, the central management with give information to and consult with the employee representatives on the enterprise s well being and any topics that the representatives wish to canvass.

The EWC has received a mixed reception from commentators. Some have argued that for most rank-and-file employees, few things related to work are likely to matter less than this annual talking shop [310] and that the information received from the

306 SI 1999/3323.
307 This was why some UK firms were covered before the opt-in. UK firms with over 1000 employees in the other Member States would be covered under the Directive.
308 Art. 2, para 1(a).
309 Art. 6, para. (d). See also Annex, para. 2 which contains a minimum structure for an EWC.
310 B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.596; *Talking Shop Soon Open for Ideas* (1994) *Financial Times* 20th April.

meeting is likely to be mumbo-jumbo. [311] Others have been more optimistic. Wheeler argues that EWCs are an extremely important development because they are the first attempt to confer *active* participation as a right upon employees rather than simply allowing them to be *passive* recipients of information.[312] In relation to the legal model of the company, it has been argued that EWCs represent a substantial departure from the neo-classical and Anglo-American notions of exclusive residual control for capital owners or their representatives. [313] Research carried out in the last few years has demonstrated that EWCs can have beneficial effects.

First, there is little doubt that EWCs have increased the communication flow and the exchange of information between employees and management. In relation to this, Rogers and Streeck argue that not only is it normatively desirable to for employees to have a say in their workplace but that a guaranteed voice for workers is also more effective than even enlightened managerial unilateralism in productively integrating capital and labour. [314] Other commentators agree stating that this exchange of information has several positive effects such as a reduction in the information asymmetries between managers and workers, and could even result in more efficient labour contracts.[315] This exchange can increase trust between managers and workers which can result in an increased willingness to engage in co-operative ventures which can in turn increase the total output of the firm.[316]

Second, it has been contended that EWCs can enhance productivity. Schnabel notes that because the works councils can hinder (or support) many managerial decisions, it could be expected that they exert a decisive influence on productivity. [317] Several

[311] *A Spanner in Europe s Works* (1995) *Economist* 2nd December. See also *This is No Way to Clinch a Deal* (1994) *Economist* 2nd April.
[312] S. Wheeler, *Works Councils: Towards Stakeholding?* (1997) 24 J. Law & Soc. 44 at 44.
[313] F.R. Fitzroy and K. Kraft, *Co-determination and Efficiency*, 1998, p.3.
[314] J. Rogers and W. Streeck, *Workplace Representation Overseas: The Works Councils Story* in R.B. Freeman (ed.), *Working Under Different Rules*, 1994, New York: Russels Sage Foundation, p.105.
[315] See B. Freeman and P. Lazear, *An Economic Analysis of Works Councils* in J. Rogers and W. Streeck (eds.), *Works Councils: Consultations, Representation, and Cooperation in Industrial Relations*, 1995, Chicago: University of Chicago Press.
[316] C. Lahovary, *Employee Representation, Codetermination and Business Performance* [Online] Available http://www.dti.gov.uk/cld/esrc2.pdf 23rd March 2001, p.7. As we shall see in Ch. 7, an economic tool called game theory will demonstrate that in order for the firm s output to be maximised, managers and employees need to sacrifice self-interest and co-operate.
[317] C. Schnabel, *Trade Unions and Productivity: The German Evidence* (1991) 29 British Journal of Industrial Relations 15 at 20.

commentators agree with Schabel s contention.[318] For example, a 1998 study by Fitzroy and Kraft suggested that works councils can provide scope for real efficiency gains in terms of both productivity and job satisfaction.[319] However, not all agree that EWCs have positive effects on productivity. Notably, those within the econometric branch of economics argue that the opposite can be true. In a 1985 comparative study of US and German firms found that works councils in the latter had a significant negative effect on productivity.[320] Frick and Sadowski stated that according to the few studies on the econometric effects of works councils found their effects on productivity to be at best inconclusive, and at worst insignificant.[321]

Linked to productivity is the issue of profitability. Lewin and Mitchell correctly note that currently the research on the economic consequences of works councils provides little evidence to support the contention that works councils increase profit.[322] Freeman and Lazear are of the same opinion. However, they then went on to say that many of the managers of US subsidiaries who had experience with EWCs believed that they did indeed increase profitability.[323]

It is still too early to determine whether or not EWCs are a success. In the UK, they have been mandatory for less than two years. However, research looking at the operation of works councils in other countries, whilst also at an embryonic stage, is hinting towards significant benefits in adopting consultation procedures of this kind.

Conclusion.

Once again, as with the position of creditors, we are forced to conclude that the protection offered to employees is not particularly effective. Their status as preferential creditors is encouraging. However, this only applies when the company

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[318] See M.M. Kleiner and Y-M Lee, *Works Councils and Unionization: Lessons from South Korea* (1997) 36 Industrial Relations 1.
[319] F.R. Fitzroy and K. Kraft, *Co-determination and Efficiency*, 1998, p.20.
[320] *Ibid.*
[321] B. Frick and D. Sadowski, *Works Councils, Unions, and Firm Performance* in F. Buttler, W. Franz, R. Schettkat and D. Soskice (eds.), *Institutional Frameworks and Labor Market Performance*, 1995, London: Routledge, pp.48-9.
[322] D. Lewen and D.J.B. Mitchell, *Systems of Employee Voice: Theoretical and Empirical Perspectives* (1992) 43 California Management Review 95 at 97-107.
[323] B. Freeman and P. Lazear, *An Economic Analysis of Works Councils* in J. Rogers and W. Streeck (eds.), *Works Councils: Consultations, Representation, and Cooperation in Industrial Relations*, 1995, Chicago: University of Chicago Press, p.33.

is insolvent, by which time, the employees will probably be more concerned with finding new employment. There are also limits on the amount that the employees can receive as preferential creditors. S.309 Companies Act 1985 does little alter the legal model of the company despite the court s creativity in a few hard cases. Similarly s.719 does not affect the legal model because its operation is dependant upon the shareholder s consent. More encouraging are the potential of EWCs in improving consultation between workers and managers. However, they are still new to this country and their effects, positive or negative, will not be known for a number of years.

CONCLUSION.

The purpose of this chapter has been to examine the legal protection available to the main groups within the corporate nexus, namely the shareholders, employees and creditors. In Part I, we examined the protection offered to the shareholders. We saw that, consistent with the legal model of the company and the new economic theory, the fiduciary duties flow to the shareholders (although technically they are owed to the company). There is even the beginning of a fiduciary duty being owed directly to shareholders, meaning that they would not be subject to the rule in Foss v Harbottle. It is therefore apparent that the law gives the shareholders considerable protection.

The same cannot be said regarding the employees and creditors. Regarding the employees, until 1980 employees had little company law protection. In 1980, s.46 Companies Act 1980 was introduced which became s.309 Companies Act 1985. As we have seen however, the protection offered by s.309 is minimal, although it is not as ineffective as many academics believe. However, the duty is owed to the company which means that employees cannot bring an action directly. The vague nature of the phrase have regard means that the directors can consider the interests of the employees and then dismiss them and act in the shareholders interests. This is entirely consistent with the legal model of the company. S.719 although superficially departing from the legal model is also consistent given that the payments require shareholder consent. The protection offered by EWCs is more encouraging, but they are still relatively new in this country and their effects are still unknown.

Similarly the protection offered to creditors is weak. The director s duty to creditors is still vague in scope and is believed by many to come into effect too late. Efforts to strengthen the duty by incorporating it into the statutory statement of directors duties have been rejected by the Government. Statutory measures have also shown themselves to be ineffective. Both s.214 and the CDDA 1986 have not lived up to their potential, not so much because of their drafting, but because of the resources devoted to enforcing them. Again efforts to strengthen these measures such as the incorporation of s.214 into the statutory statement of directors duties have been frustrated by the Government.

One is therefore forced to conclude that in terms of the legal protection on offer, UK company law is still dominated by the legal model of the company. Much of the protection that exists benefits the shareholders and those measures aimed at non-shareholder constituents are inadequate. In the next chapter, we will examine the various corporate governance mechanisms that UK company law provides for. It will be seen that like the measures in this chapter, the vast majority of mechanisms offered exist to offer protection to the shareholders. The two taken together indicates that the legal model of the company is still the dominant model in the UK.

5

Corporate Governance Mechanisms

In July 1985, Houston-based Natural Gas merged with Omaha-based InterNorth to form a new company called Enron. Kenneth Lay, a prominent energy economist, became chairman and CEO. Lay wanted to take this new company beyond the business of piping gas and place it at the heart of the energy trading business.

In the 1980 s, energy corporations lobbied Congress to deregulate the industry. Corporations, including Enron, stated that the extra competition would benefit both companies and consumers. Washington complied and lifted controls on who could produce energy and how it was sold. New suppliers came to the market and competition increased. In these free-market conditions, however, the price of energy became volatile.

Enron saw a chance to make money out of these price fluctuations. It decided to act as middle man and guarantee stable prices — taking its own cut along the way. In a few short years, Enron became a massive player in the US energy market, controlling at its height a quarter of all gas business. Buoyed by this success, the company went on to create markets in many other energy-related products as well as expanding into international energy markets.

As the dot.com economy prospered, Enron began 2000 with a plan to move into broadband internet networks. This idea appealed to investors and the share price soared. It was about this time that Enron began to use sophisticated accounting techniques to keep its share price high, raise investment against its own assets and stock and maintain the impression of a highly successful company. It also started legally removing losses from its books and passing them on as assets to independent partnerships. Equally, investment money flowing into Enron from new partnerships ended up on the books as profits, even though it was linked to specific ventures that were not yet up and running.[1]

By the summer of 2000, Enron s shares had hit an all-time high of $90. However, there was also controversy. Enron s 2000 annual report reported global revenues of £100 billion — a rise of 40% in three years. In reality, total revenue would have been far lower were it not for the aforementioned partnerships created by finance director Andrew Fastow.

Enron s growth was becoming increasingly dependant on these accounting tools. Enron made investments and then shifted the debt off its books to theoretically independent partnerships, in return for potential income that provided a buffer against future losses.

Then suddenly, on 14th August 2001, Jeff Skilling resigned as CEO citing personal reasons. Kenneth Lay once again became CEO. Skilling s resignation came as a shock to investors who suddenly feared that all was not well. Investors sold millions of shares, knocking some $4 off of the share price. Skilling s resignation also shed light on a previous departure. In May 2001, another executive, Clifford Baxter left in apparently uncontroversial circumstances. However, Skilling s resignation triggered rumours that he and Baxter had clashed over the propriety of some of the partnership transactions. Soon after, Baxter committed suicide.

The problems facing Enron were beginning to dawn on Andersen. They realised that as Enron had hedged against its own stock, it could never recover its losses whilst the share price was falling. Andersen warned Enron that it had no choice other than to abandon its special accounting procedures. Soon after this, staff in Andersen s Houston office began shredding documents relating to Enron.

On the 8th November 2001, Enron took the highly unusual step of restating its profits for the past four years. By doing this, Enron effectively admitted that it had inflated its profits by concealing debts in the partnership arrangement. The following day, Enron entered negotiations to be taken over by its much smaller rival, Dynegy.

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[1] One such venture was to distribute Blockbuster videos by broadband connections. The plan fell through, but Enron had already posted $110 million venture capital as profit.

On the 2nd December 2001, Enron filed for bankruptcy in a New York court, simultaneously launching a legal action against Dynegy for pulling out of the merger. In three months, Enron had gone from being a company claiming assets worth almost £65 billion to bankruptcy. Its share price collapsed from about $95 to below $1.

On the 9th January 2002, the Justice Department announced a criminal investigation into Enron focusing on allegations of fraud. Andersen s role also came under scrutiny after it admitted disposing of Enron documents.

Scandals such as Enron and Worldcom have brought about calls for a tightening of the internal controls that regulate companies.[2] Since Enron especially, corporate governance has started to dominate political and business agendas.[3] On an economic level, scandals such as those above have had significant impacts on corporate efficiency. Many theorists therefore assert that corporate governance mechanisms are required in order to maximise efficiency. Over time, governance mechanisms contribute to long-term corporate prosperity. Accordingly, sophisticated investors will not invest unless their interests are sufficiently protected and, therefore, an effective array of governance mechanisms should be in place in the vast majority of companies.

However, whilst it may be the activities of a few nefarious characters that has caught the public s attention, the corporate governance debate has been going on for many years in academic circles, and has a much deeper significance. It is the purpose of this chapter to examine the various mechanisms that are designed to improve standards of corporate governance. The term corporate governance, although now commonplace, was rarely encountered before the 1990s. Its rapid adoption by the academic community however, has not been accompanied by consistent usage. Different writers apply different parameters to the subject. As has been noted [i]n its narrowest sense, the term may describe the formal system of accountability of senior management to the shareholders. At its most expansive the term is stretched to include the entire network of formal and informal relations involving the corporate

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[2] See Committee on Corporate Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice*, 1998, Principle D.2 appended to Financial Services Authority, *The Listing Rules*, May 2000, London: FSA.

sector and their consequences for society in general. [4] Whilst the latter definition may be too broad for, it is contended that the former definition is too narrow. However, an examination of the various mechanisms in place reveals that the former definition has had more influence. The vast majority, if not all, of the corporate governance mechanisms that will be examined exist to protect the shareholders or to give the shareholders some ability to influence management. This supports the view that the legal model of the company is still an intrinsic part of our corporate governance system.

Parts I-IV will examine the internal mechanisms. Part I will look at the key mechanism as far as the shareholders are concerned, namely the AGM. Part II will examine the increasingly prominent role being played by institutional investors and the limitations upon their effectiveness. Part III will examine the issue of board reform, notably the role and effectiveness of non-executive directors. Part IV will examine a corporate governance issue that has also aroused public concern, namely executive pay. The general perception is that these internal mechanisms provide only weak sources of accountability and so the Anglo-American system of corporate governance relies on an external mechanism, namely the hostile takeover market. The takeover market as a corporate governance mechanism is known as the market for corporate control and will be examined in Part V. The effectiveness of these mechanisms and the individuals who they are designed to protect will be examined.

I. SHAREHOLDER VOTING POWER AND THE ANNUAL GENERAL MEETING

Introduction.

General meetings are fundamental to the company for two reasons. First, from a company law standpoint, they are important because company law reserves certain decisions in the running of the company to the shareholders in general meeting. Second, from a corporate governance point of view, they are important because they provide the shareholders with an opportunity to hold the board of directors

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[3] KPMG, *Corporate Governance: The New Strategic Imperative*, 2002, London: KPMG, p.1.

[4] K. Keasey, S. Thompson and M. Wright, *Introduction: The Corporate Governance Problem — Competing Diagnoses and Solutions* in K. Keasey, S. Thompson and M. Wright (eds.), *Corporate Governance: Economic, Management and Financial Issues*, 1997, New York: OUP, p.2.

accountable and ask them questions about corporate performance. In fact the AGM appears to provide the only formal link between the two key governance bodies of the company, the members in general meeting and the directors. [5]

However, despite their importance, there has been a long-held recognition that AGMs do not fulfil their functions, particularly the governance function, adequately. The Cadbury Committee concluded:

> If too many annual general meetings are at present an opportunity missed, that is because shareholders do not make the most of them and, in some cases, boards do not encourage them to do so. [6]

This concern was echoed by the City/Industry Working Group under the chairmanship of Paul Myners of Gartmore plc. whose report was published in 1995.[7] The Group stated that virtually all participants in their consultation expressed the view that the AGM as it presently stands, forms an expensive waste of time and money. They concluded that:

> We believe the AGM is too important to leave as it is. We seriously considered proposing that current legislation should be amended to permit shareholders to opt out of the requirement to have an annual meeting . However, we favoured a second option, which was to retain the statutory backing for the AGM but to change its format, so that major investors see value in attending. [8]

Given the importance of the AGM in providing the shareholders with a voice in company matters, it must be viewed as an important element of the legal model. As noted, a number of fundamental company issues can only be decided upon by the members in meeting. The existence of the AGM as a means of deciding these issues is therefore a critical part of the legal model.

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[5] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Company General Meetings and Shareholder Communication*, October 1999, London: DTI, para. 16.

[6] *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para. 6.7. See also Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Company General Meetings and Shareholder Communication*, October 1999, London: DTI, paras.3-4:

> AGMs are often described as the key mechanism whereby shareholders hold the managers of companies to account . In principle at least, then, AGMs are the key mechanism for promoting transparency and accountability in the management of company affairs. But in practice there is wide agreement that they do not usually achieve these objectives very satisfactorily.

[7] P. Myners, *Developing a Winning Partnership: How Companies and Institutional Investors are Working Together*, September 1996, London: DTI.

[8] *Ibid.* at p.12.

However, whilst the legal model s influence is evident from the sheer scope of the issues that have to be determined in meeting, the value of the AGM to the shareholders is lessened by a number of procedural and practical constraints that almost render it obsolete from the point of view of most shareholders.

The Scope of Shareholder Voting Power.

We have noted that, from a company law standpoint, the AGM is important because certain decisions are reserved for the shareholders in general meeting. This reservation of powers is a major facet of the legal model. Accordingly, before we can analyse the effectiveness of the AGM as a means of improving governance standards, we need to examine the scope of the shareholders power to vote at the AGM. If very few issues require shareholder approval, then the potential of the AGM as a mechanism of accountability is reduced.

Shareholders of a company have a right to vote where this is provided for by legislation, case law or through the company s articles of association. For companies listed on the London Stock Exchange, *The Listing Rules* provide a number of additional matters that require shareholder approval. Here, the principal matters that require shareholder approval will briefly be examined in an attempt to demonstrate that, at least theoretically, there still remains potentially significant residual power in the hands of the shareholders.

Constitutional changes, such as decisions to alter the objects[9] or articles[10] of a company must be approved by special resolution of the shareholders in general meeting. This is hardly surprising as a change to the company s constitution affects the bargain between the shareholders and the company. Other constitutional changes, such as increases in authorised share capital[11] and variations of class rights[12] also require shareholder approval.

[9] S.4 Companies Act 1985.
[10] S.9 Companies Act 1985.
[11] S.121 Companies Act 1985.
[12] Ss.125-7 Companies Act 1985.

A change in corporate status *e.g.* conversion from a private to a public company, will require the passing of a special resolution.[13] The exception to this is the conversion from a limited company to an unlimited one. This will require the consent of all the shareholders[14] as, following the resolution, they will all become personally liable whereas once their liability was limited.

The dissolution of the company may also be a matter for shareholder sanction. It is a matter for the shareholders, not the directors whether or not to voluntarily wind up the company. To do this requires the passing of either a special or extraordinary resolution.[15]

If a company wishes to raise capital by issuing shares, then it will need some form of shareholder approval in order to do it. The company will need either to pass an ordinary resolution or add a provision to the articles given them such a power (Table A contains no such provision).[16] Both public and private companies need to obtain such authorisation, but the duration of the authorisation differs according to the type of company.[17] Shareholder approval is also required if a company wishes to reduce its capital.[18]

Certain transactions involving directors also require shareholder sanction. Substantial property transactions, broadly those exceeding £100,000 or 10% of the company s net assets, between the company and any of its directors must be approved by an ordinary resolution,[19] as must advances made to a director to meet expenditure or for the purpose of enabling him properly to perform his duties.[20] The making of gratuitous payments to directors losing office is also subject to shareholder approval by way of

[13] S.43 Companies Act 1985 (private company converting to plc.), s.51 Companies Act 1985 (unlimited company becoming limited company), s.53 Companies Act 1985 (plc. becoming a private company).
[14] S.49 Companies Act 1985.
[15] S.84 Insolvency Act 1986.
[16] S.80 Companies Act 1985.
[17] A public company s authorisation period is limited to five years (ss.80(4) and 80A(2) Companies Act 1985), whereas a private company, if it takes advantage of the special procedure contained in s.80A Companies Act 1985, can have a longer authorisation period or even an indefinite one.
[18] S.135 Companies Act 1985.
[19] S.320 Companies Act 1985.
[20] S.337 Companies Act 1985.

ordinary resolution.[21] Perhaps most importantly, the shareholders can remove directors from office by passing an ordinary resolution.[22]

Shareholders also gain residual power from the articles of association. Table A (which most companies base their articles on) provides for shareholders to nominate[23] and appoint[24] directors and for shareholders to fix the remuneration of non-executive directors.[25] It also ensures that shareholders have an opportunity to consider the board s performance by requiring one-third of them to retire annually, although they may stand for re-election.[26]

Another superficially important power granted to shareholders by Table A relates to dividends. It is for the shareholders, not to directors, to declare a dividend.[27] However, the shareholders cannot recommend an amount greater than that recommended by the directors and so, in reality, the shareholders usually do little more than ratify the board s decision.

The articles of listed companies normally deviate from Table A so as to give shareholders a greater say on certain matters. For example, it is common amongst listed companies to have a provision in the articles that limits the borrowing power of the directors,[28] and if the directors wish to exceed that power, they will require shareholder approval. These will be in addition to the additional obligation imposed on listed companies by *The Listing Rules* (*e.g.* the rules relating to shareholder approval of substantial acquisitions and disposals).[29]

It is therefore apparent that, theoretically, there is still a large amount of residual power in the hands of shareholders. This must be due in part to the influence of the legal model of the company. However, in order for the philosophy behind the legal

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[21] S.312 Companies Act 1985.
[22] S.303 Companies Act 1985.
[23] Art.86 Table A. Note that the board can also nominate new directors.
[24] Art.78 Table A. Note that art.79 Table A gives the board a limited power to appoint directors.
[25] Art.82 Table A. Executive remuneration is determined by the board (art.84 Table A).
[26] Art.73 Table A.
[27] Art.102 Table A. Although the directors may pay interim dividends without shareholder approval (art.103 Table A).
[28] Versions of Table A prior to 1985 imposed a borrowing limit.
[29] Financial Services Authority, *The Listing Rules*, 2000, London: FSA, Ch.10.

model to be fully realised, the shareholders need to effectively exercise these powers. However, the procedural rules relating to the conduct of AGMs make this extremely difficult for most shareholders to do. It is these rules that we now turn to.

The Rules Relating to General Meetings.

In the case of *Re Dorman, Long & Co.Ltd.*,[30] Maugham J examined the effectiveness of the AGM as it was then and in the late nineteenth century. He stated that in the late nineteenth century all persons could go to the meeting, listen to what was said, and vote for or against the proposal according to the views expressed at the meeting. Conversely, in 1933, at the time of the case, he found that only a fraction of persons could attend meetings and in the majority of cases, proxies given before the meetings had already decided the outcome of the resolution. In a statement that does little to inspire confidence in the effectiveness of the AGM, he stated:

> In a sense the dice are loaded in favour of the views of the directors: the notices and circulars are sent out at the cost of the company, the board have had plenty of time to prepare the circulars. All the facts of the case are known to them, proxy forms made out in favour of certain named directors ... If we contrast with that the position of a class of objectors, it is to be observed that a member of the class who receives notice of the meeting and a circular from the directors is generally alone: he has no funds with which to fight the case and he has no information, except sometimes that information which has been contained in reports and balance sheets which have probably long ago been relegated to the waste paper basket. In any case, he has a minimum of information, his personal interest in the matter may be exceedingly small, probably he knows a few persons in the same position as himself and, if he manages to get in touch with them, they together have to raise funds for the purposes of an opposition, which is often an expensive matter. They have then to get the names and addresses of the members of the class who are concerned, and to frame and send out a circular representing their views. Very often there is scarcely sufficient time for those purposes between the moment when notice of the meeting reaches objectors by post and the date of the meeting. [31]

Developments since 1933, notably the increased scope of institutional investment and the consequent decrease in scattered shareholders, makes it appropriate to reconsider whether or not the dice are loaded still in favour of the directors. This will be done by examining the procedural rules relating to the conduct of general meetings.

[30] [1934] 1 Ch. 635.

Calling General Meetings.

The power to call company meetings is usually vested in the board of directors by the articles of association.[32] This power is a fiduciary one which must be exercised in good faith, in the interests of the company as a whole[33] and for a proper purpose. Further, the Companies Act 1985 provides for a variety of consequences should the directors fail to use this power correctly.[34]

The shareholders do have a non-excludable power to call an AGM. Under s.368 Companies Act 1985, a meeting can be called by shareholders providing that they hold not less than one-tenth of the voting rights in the company. The case of *McGuinness v Bremner*[35] established that delay to hold an EGM following a member s requisition could amount to unfairly prejudicial conduct. This case highlighted a then loophole in the law in that although the directors were obliged to call a meeting at a specified time, there was nothing stopping them from fixing that time at some point far into the future. This loophole was closed by s.368(8) Companies Act 1985 (as inserted by Companies Act 1989) which requires the directors to fix the date of the meeting not more than 28 days after the date of the notice by which the meeting is convened. The practical effect of this is that it restricts the time that the directors have to prepare their response to the shareholders motion.

Given that it would be impractical to allow every shareholder the right to call a meeting, one could argue that the 10% requirement is reasonable. However, in reality, the s.368 power in only likely to be used by small coalitions of institutional investors. For most private investors, the 10% threshold will almost certainly present an insurmountable barrier. Accordingly, the power to call meetings is not overly pro-director, but it is only likely to be used by institutional investors and, as we shall see later in the chapter, they have their own barriers to activism.

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[31] *Ibid.* at p.657.
[32] Art.37 Table A. This displaces s.370(3) Companies Act 1985 which, in the absence of a contrary provision in the articles, gives two or more shareholders holding not less than one-tenth of the issues share capital the right to call a meeting.
[33] *Pergamon Press Ltd. v Maxwell* [1970] 1 WLR 1167.
[34] For example, if the AGM is not held as required by the Companies Act 1985, the company and every officer who is in default is liable to a fine (s.366(4)). Repeated failure to call an AGM may amount to unfairly prejudicial conduct under s.459 Companies Act 1985 (*Re a Company ex parte Shooter* [1990] BCLC 384).
[35] [1988] BCLC 673.

Drawing Up a Notice of a Meeting: Controlling the Agenda and the Circulation of Information.

The notices of AGMs are normally drawn up by the directors. This is an important power because of the rule that, apart from any matters designated as ordinary business in the articles, only those matters of which notice has been given can be discussed at a meeting.[36] S.376 Companies Act 1985 requires that the company give shareholders notice of resolutions that they wish to put to the next AGM. S.376 also provides for the circulation of shareholders statements. The fact that most shareholders do not physically attend meetings and vote by proxy, if they vote at all, means that it is important for shareholders to explain the reasons for their own resolutions well in advance of the meeting.

In 1996, the DTI published a consultation document[37] seeking views on whether companies should be required to circulate shareholders resolutions for the AGM and accompanying statements without charge, provided they were submitted by a given deadline. The DTI s primary concern was the difficulties faced by individual private investors in accessing the machinery of corporate democracy. The contrast here between the position of the board and that of shareholders who wish to table a resolution opposing the management is stark. The directors are permitted to use the company s funds bona fide and reasonably for the purpose of obtaining the best expression of the voice of the corporators in general meeting. [38] Within the boundaries of their fiduciary duties, the directors can, at the company s expense, send out circulars explaining why the shareholders should support their resolutions. Conversely, shareholders who wish to table a resolution will have to pay for much of it themselves. The costs of providing notice to the shareholders by mail alone may be between £50,000-100,000.[39] Accordingly, this appears to be one area where the dice are still loaded in the management s favour. This is borne out in that in practice

[36] *Kaye v Croydon Tramways* [1898] 1 Ch. 358; *Normandy v Ind. Coope & Co.* [1908] 1 Ch. 84.
[37] DTI, *Shareholder Communications at the Annual General Meeting*, April 1996, London: DTI.
[38] *Peel v London and NW Railway* [1907] 1 Ch. 5 at 18, *per* Buckley LJ.
[39] DTI, *Shareholder Communications at the Annual General Meeting*, April 1996, London: DTI, para. 2.11.

resolutions are nearly always proposed and moved by the directors, not by the shareholders.[40]

Given this, the Company Law Review Steering Group has recommended that companies should bear the cost of circulating shareholder resolutions subject to a voting threshold and their timely filing.[41]

Ordinary Business at AGMs.

By convention, the matters normally discussed at AGMs are reasonably predictable; *e.g.* the annual accounts, auditor s reports, the election of directors *etc.* This predictability is useful to shareholders. For example, the retirement by rotation provisions that will be included in the articles of listed companies ensure that at each AGM the composition of the board will be under review, and shareholders can thus prepare for it in advance.

Shareholders can also use the predictable nature of the AGM to prepare questions in advance of the meeting. The function of the AGM as a forum for questions is more important for private investors and small institutional investors than for large institutional investors. This is because the company s large institutional investors will be able to ask questions and express their views at informal meetings with the management. Currently, there is no detailed mechanism governing shareholders questions at AGMs but as a matter of practice, many companies do permit shareholders to ask questions and do not confine them to the formal resolutions on the agenda. This is supported by the Combined Code which states that boards should use the AGM to communicate with private investors and encourage their participation.[42]

Accordingly, it can be seen that the rules relating to the conduct of AGMs are not totally pro-director. Some legislative rules do indeed make the shareholders role as monitor more difficult to achieve, but they are not so extensive as to fully explain the

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[40] *Ibid.* at para. 2.8. Although there is some evidence of greater use of the provisions by shareholders in privatised utilities.

[41] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, November 2000, London: DTI, para. 5.33.

[42] *The Combined Code: Principles of Good Governance and Code of Best Practice*, 1998, para.C.2, appended to Financial Services Authority, *The Listing Rules*, 2000, London: FSA.

current inability of the AGM to act as a medium for corporate democracy. Accordingly, if the law cannot fully account for the AGMs failings, we must look elsewhere.

The AGM in Practice.

An examination of the AGM in practice reveals the basis for the current dissatisfaction with the AGM. It has been contended that the AGM can only be an effective form of governance if two conditions are met. Firstly, the majority of the shares should be held by members who are not directors. Secondly, all or most of the members should be willing to participate in the AGM.[43] Unfortunately, only one or neither of these conditions are present in companies at either end of the size spectrum.

As regards small owner managed companies, the shares are held wholly or mainly by the directors. These companies are run informally without reference to company law for the main. In such companies, where the directors and shareholders are the same people, formal general meetings serve little or no use. This was recognised when, in 1989, rules were introduced permitting private companies to dispense with the AGM by unanimous resolution.[44] The Company Law Review Steering Group recommends extending this exclusion by totally removing the obligation upon private companies to hold an AGM, unless they choose to opt into the AGM regime.[45]

The AGM fails for a different reason in the case of large public companies. Here, there may be hundreds of thousands of members living in all parts of the UK and abroad. It is impracticable for more than a tiny minority of them to attend a general meeting.[46] Moreover, it is unusual for institutional investor representatives to attend AGMs; they exercise their power in other ways.

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[43] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Company General Meetings and Shareholder Communication*, October 1999, London: DTI, para. 18.

[44] S.379A(1)(c) Companies Act 1985, as inserted by s.116 Companies Act 1989.

[45] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, June 2001, London: DTI, para. 7.6.

[46] Although recently, representatives of pressure groups have been starting to exercise their rights as shareholders to draw attention to wider social or environmental concerns. Whilst it is only proper that directors should face questions on such issues, the activities of some of these groups are disruptive and only serve to increase the cost of the AGM as companies are now having to spend more on security arrangements.

Given this failing, there have been calls for a provision, similar to that for private companies, that would permit public companies to dispense with the AGM.[47] However, the governance function that the AGM is supposed to perform must remain enshrined in law and so public companies would have to replace the AGM with a governance mechanism that was less cumbersome and more effective. Unanimity to dispense with the AGM would not be required given the practical difficulties of obtaining this.[48] The Company Law Steering Group s March 2000 report thought that this would be premature.[49] However, following consultation, their November 2000 report recommended that public companies should be free to dispense with the AGM by elective resolution or if secondary legislation so permits.[50] This has now become a recommendation of the final report.[51]

However, surely it would be more preferable to improve the workings of the AGM rather than to reluctantly accept its inadequacies and quietly dispense with it. Accordingly, a number of recommendations have been voiced aimed at improving the AGM s effectiveness.

One possible improvement is to encourage the use of dispersed meetings. A dispersed meeting is a meeting held at more than one location, with real-time communication between participants. Many believe that such a meeting is already permissible under s.366 (indeed some companies already hold dispersed meetings) but that the law should be clarified to state this.[52] Accordingly, the Company Law Review Steering Group recommends that any statutory provision relating to this should be enabling, so as not to frustrate any future technological developments.[53]

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[47] See The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Company General Meetings and Shareholder Communication*, October 1999, London: DTI, paras. 24-7.
[48] *Ibid.* at para. 26.
[49] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, March 2000, London: DTI, para. 4.27.
[50] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, November 2000, London: DTI, paras. 5.18-19.
[51] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, June 2001, London: DTI, para. 7.6.
[52] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, March 2000, London: DTI, para. 4.31.
[53] *Ibid.*

Also provisions in any future Table A should be included to permit dispersed meetings.[54]

Conclusion.

The quote at the beginning of this section highlighted a general consensus concerning the AGM, namely that it is the key mechanism in making directors accountable to the shareholders. However, the limitations discussed are also generally accepted by commentators. It also appears that there is an unspoken feeling that the AGM as a form of governance accountability is becoming increasingly moribund. Private companies can now totally dispense with the AGM under the elective resolution procedure and if the Company Law Review Steering Group s recommendations are adopted, then public companies will be able to do the same. This appears to be part of a consensus that the AGM does not work, is inefficient and costly and in practice, does not increase accountability. Ideas for reform have been *ad hoc* and would only improve matters slightly.

The existence of the AGM is a pure product of the legal model of the company. By requiring companies to hold AGMs, shareholders have an opportunity to take part in management in a limited sense. However, only the shareholders have a right to participate in the AGM, yet their residual powers can also have significant effects on other stakeholders. In the previous chapter, we noted that the shareholders have the power under s.719 to grant *ex gratia* payments to employees. The shareholders have the power to increase or decrease the capital that is (theoretically) kept inviolate for the creditors by the capital maintenance regime. Altering capital can have a significant effect on the creditor s default risk, yet the matter is entirely left to the discretion of the shareholders.[55] Finally, the shareholders in general meeting have the power to wind the company up — an act which will affect all parties concerned with the company. Given this, a number of academics have argued that certain non-shareholder constituents should also have the power to vote at AGMs. Accordingly, one is forced to conclude that despite the AGM s obvious flaws, it upholds the legal

[54] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, November 2000, London: DTI, para. 5.22.
[55] Although there do exist statutory safeguards to protect the creditors.

model of the company and confirms the legal model s central contention that the company should act in the interests of its members.

II. INSTITUTIONAL INVESTORS.

The Scope of Institutional Investment.[56]

In 1963 financial institutions[57] held approximately 29% of listed UK equities; 34% in 1969, 47% in 1975, 58% in 1981 and 60% in 1992.[58] In 1998, the figure is estimated at 70%.[59] The Myners Report states that today, over £1,500 billion of assets lie in the hands of institutional investors.[60] In America, this concentration is even more pronounced in the larger corporations.[61] Trends indicate that this increase in institutional investment will continue. An obvious consequence of a rise in institutional investing is a concomitant decrease in the proportion of individual shareholding. In 1963, individual shareholdings stood at 54%; by 2000 this figure was 16%.[62] It is further contended that the institutional concentration is even greater than the figures show as day-to-day management of certain institution funds is delegated to a relatively small number of investment houses.[63] For example, a study carried out in 1984 revealed that approximately one third of all UK pension funds were managed by 15 fund managers, mainly merchant banks.[64] Such statistics are

[56] It is acknowledged that whilst a rise of institutional investing is obvious, the actual figures themselves vary.
[57] For our purposes, the term institutional investor will be used unless otherwise stated to denote insurance companies, pension funds, unit trusts, investment trusts and open-ended investment companies (OEIC s). Unlike Germany and Japan, banks are not major institutional investors, holding about 0.1% of the British equities market. See P.L. Davies, *Institutional Investors in the United Kingdom* in T. Baums, R.M. Buxbaum & K.J. Hopt (eds.), *Institutional Investors and Corporate Governance*, 1994, Berlin; New York: de Gruyter, p.258.
[58] Office for National Statistics, *Share Ownership: A Report on the Ownership of Shares at 31st of December 1997*, 1999, London: The Stationary Office, p. 8, Table A.
[59] G. Stapledon, *Analysis and Data of Share Ownership and Control in UK* [Online] Available http://www.dti.gov.uk/cld/staple.pdf, 28th March 2000, p.4. Although the Hampel Committee placed it closer to 80%.
[60] P. Myners, *Institutional Investment in the United Kingdom: A Review*, 2001, p.4.
[61] In Amoco, institutional concentration is 86%, General Motors Corp. (82%), Mobil Corp. (74%), Eli Lilly & Co. (71%) and Citicorp (70%). See J.C. Coffee Jnr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor* (1991) 91 Colum. L. Rev. 1277 at 1291.
[62] Office for National Statistics, *Share Ownership: A Report on the Ownership of Shares at 31st of December 2000*, 2001, London: HMSO, para.2.3. However, pension funds and insurance companies derive the bulk of their funds from individuals so individuals may play a larger part than the figures suggest.
[63] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p. 166. See also CBI, *Pension Fund Investment Management*, 1987, London: CBI, p.54.
[64] T. Schuller, *Age, Capital and Democracy*, 1986, Aldershot: Gower, pp.95-6.

important as pension funds constitute the largest class of institutional investor at 31% of the market.[65] This eclipse of the private individual by the institutions challenges the traditional model of the corporation based on the separation of ownership and control and the concomitant rational apathy of the shareholders. This concentration of assets creates potential for intervention in the corporate governance matters of portfolio companies.[66] This in turn may re-ignite the shareholders ability to effectively participate in the governance of the company. The separation of ownership and control discussed in Chapter 2 may thus be halted or even reversed.

From a corporate governance standpoint, perhaps more importantly than the overall market concentration of equities held by institutions is the amount held by a single institution in any one company. Whilst it is commonplace for institutions to hold a diversified portfolio in order to minimise risk,[67] an institution s stake may nevertheless be significant enough to affect the share price if sold back to the market. This could have the effect of locking institutions into their portfolio companies.[68] If such an institution becomes dissatisfied with the way a company is run, the only realistic choices available will be to remain passive, or to take steps to improve performance.

An institution s potential to exact change becomes even more compelling when institutions coalesce. In 1961, Professor Florence argued that the twenty largest shareholders often held enough shares to effectively control even the largest British corporation.[69] In 1986, John Scott re-examined this contention.[70] He discovered that ownership concentration had fallen and that the top twenty institutions never had

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[65] B.S. Black & J.C. Coffee Jnr., *Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation* (1994) 92 Mich. LR. 1997 at 2008.
[66] This potential has been recognised for some time; see A.A. Berle, *Power Without Property: A New Development in American Political Economy*, 1960, London: Sidgwick & Jackson, p.53.
[67] As of 1998, Prudential, the UK s largest institutional investor, held 3.87% of the market share. By necessity this means that it holds an average of 3.87% of the equities of each company it invests in. Of course, some will be less, some will be more. See Dr. G. Stapledon, *Analysis and Data of Share Ownership and Control in UK* Available [online] 28th March 2000 http://www.dti.gov.uk/cld/staple.pdf, p.6.
[68] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.167.
[69] P. Sargant Florence, *The Logic of British and American Industry*, 1961 (rev.ed.), London: Routledge & K. Paul, p.192.
[70] See J. Scott, *Capitalist Property and Financial Power: A Comparative Study of Britain, the United States and Japan*, 1986, Brighton: Wheatsheaf Books. See also J. Scott, *Corporate Control and Corporate Rule: Britain in an International Perspective* (1990) 41 Brit. J. Soc. 351.

control but instead held around 20-29% of the voting stock.[71] Scott s data is useful for two reasons. Firstly, by comparing it to recent data, we can see that there has been an increase in concentration when compared to 1977. One commentator has contended that the largest twenty-five shareholders hold an absolute majority of the shares of many British corporations.[72] A recent consultation document states that the twenty largest institutions control 37.06% of the UK equities market.[73] Second, Scott s data shows that although the figures have changed the institutions have not. The same institutions cropped up time and time again. For example, Scott examined the top twenty shareholders in the top 100 corporations and found that Prudential Assurance appeared 88 times.[74]

Accordingly, the UK appears comparatively well suited for institutional intervention. As we have seen, ownership concentration is high. The institutional environment in the UK is close-knit in that most institutional investors are based within a small area in the City of London. Institutional shareholders can communicate quite easily, both through formal committees and through more informal professional contact. For example, insurance companies views on corporate governance tend to be channelled through the investment committees of their trade association, the Association of British Insurers (ABI). The National Association of Pension Funds Ltd. (NAPF) performs the same function for pension fund investors. This type of formal and informal contact creates the potential for monitoring on a more cost-efficient basis than could ever be achieved by individual shareholders acting independently. Finally, the legal environment is conducive to institutional ownership as communication between institutions is largely unregulated. Conversely, in America, securities law prescribes a variety of constraints and restrictions on institutional behaviour.[75] Further, active institutions have more onerous duties than passive ones.[76] The UK s

[71] *Ibid.* at p.95.
[72] T. Jackson, *The Institutions Get Militant* (1991) *Financial Times* June 11th at 18.
[73] Dr. Geoff Stapledon, *Analysis and Data of Share Ownership and Control in UK* Available [Online] 28th March 2000 http://www.dti.gov.uk/cld/staple.pdf, p.6.
[74] J. Scott, *Capitalist Property and Financial Power: A Comparative Study of Britain, the United States and Japan*, 1986, Brighton: Wheatsheaf Books, p.100.
[75] *E.g.* owning a 5% stake triggers filing requirements under s.13(D) Securities Exchange Act (15 U.S.C. /78m(d)). Owning a 10% stake triggers short-term profit forfeiture under s.16(b) Securities Exchange Act (15 U.S.C./79p(b).
[76] For example, an active shareholder must make costly filings under the Hart-Scott Radino Premerger Rules; a passive shareholder is exempt.

legal environment therefore appears more conducive to activism than America s.[77] The question that needed to be asked is this conducive environment enough to foster a climate of institutional activism. This issue will now be examined.

Examples of Institutional Activism.

One possible reason for the notion that institutional activism is rare is due to the fact that British institutional investors have a reputation for behind-the-scenes negotiation. One reason for this is that if a large institutional investor were to publicly display dissatisfaction with the way that a company is being run, it could trigger a race to exit. If the institutional investor did not feel that their grievance was adequately resolved they might sell their stock, thereby depressing the stock s price. If this dissatisfaction was made known to other institutions, they may decide to sell their stock first before the stock price drops,[78] although some fund managers considered such behaviour unethical or even constituting insider trading.[79]

However, despite this, there are examples of instances when a coalition of institutional investors publicly voiced their dissatisfaction and attempted to remove a board of directors.[80] Our task is to examine these instances and determine whether

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[77] One commentator has said of American situation:

> No single legal rule forecloses shareholder action. But the obstacles are many, and their cumulative effect is large. A shareholder who remains quiet is safe. A shareholder who buys a large stake, especially a shareholder who becomes active on governance issues, pays a price. That price, for a shareholder whose stake is kept small by legal rules, is often enough to make passivity the preferred course.

See B.S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice* (1992) 39 UCLA. L. Rev. 811 at 824.

[78] One fund manager phrased the problem thus:

> You must remember that in communicating dissatisfaction, you are possibly giving a signal of your future intentions. Would a person you are talking to abuse the information by trading on it? You have to fear a race to the exit in which you will be last by staying to challenge management.

Quoted in B.S. Black & J.C. Coffee Jnr., *Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation* (1994) 92 Mich. LR. 1997 at 2062.

[79] S.57(2)(a)(i) Criminal Justice Act 1993 defines insider to include shareholders.

[80] Of course, often the removal of a director or directors helps avoid a public display of dissatisfaction. In 1995, Maurice Saatchi was forced to resign as chairman of the advertising group Saatchi & Saatchi (since renamed Cordiant) plc. by a group of institutional investors holding about 30% of the company s stock. He summarized the situation thus:

> By threatening the Directors with an Extraordinary General Meeting - at which they could outvote others - they have given the Directors their orders: Take your Chairman into a corner and shoot him quickly-we don t want the fuss of a public trail.

See S. Schiff, *Master of Illusion* (1995) *New Yorker* May 15th 52 at 66.

they suggest a systematic increase in institutional activism or if they represent anomalous shareholder behaviour.

The first example arose in 1991 when a coalition of institutions led by Norwich Union, one of Britain s largest insurance companies,[81] attempted to replace the board of Tace plc.[82] Press accounts branded the Tace board as inefficient, although it is believed that the real grievance was the inordinately high compensation paid to Tace s founder. One shareholder complained to the Bank of England about this excessive remuneration. Avoiding direct involvement, the Bank of England advised the shareholder to contact Norwich Union, which held 5% of Tace s shares.

Negotiations began between the institutions and the Tace board over the selection of a new CEO. However, without consulting the institutions, the Tace board selected a replacement that the institutions found unacceptable due to his close associations with the previous CEO. Insulted by this, the CEO of Norwich Union and coincidentally, the chairman of the Institutional Shareholders Committee, E.M. Sandland, lined up two other institutional shareholders - Framlington and GT Management - to share the cost of the campaign to oust Tace s management. Framlington, which held 16% of Tace s shares, stayed with the campaign, but GT Management soon pulled out.

Tace s management did not remain passive; it used its own investment bankers to contact shareholders and assemble a friendly 29% block of shares. Eventually however, Norwich Union assembled proxies from 40% of Tace s shareholders, called an emergency general meeting of the shareholders and voted the board out of office.

What at first may seem to be a victory for the institutions is, when examined, a Pyrrhic Victory at best. Although the media praised Sandland and Norwich Union for taking the big corporations on, Sandland s actions were questioned by his own board and other fund managers. They accused him of headline hunting and criticised an un-British approach that would only serve to embarrass the City. Further, Norwich

[81] By 1998, Norwich Union was the 13th largest institutional investor and the 6th largest insurance company in the UK with 1.36% of the total market share.

[82] For piecemeal accounts of this story, see R. Gourlay, *4.4% Holding in Tace Changes Hands* (1991) *Financial Times* June 24th at 18; R. Gourlay, *Institutions Launch Bid to Oust Tace Board* (1991)

Union and Framlington had to split between them a £60,000 bill for solicitor s expenses.

In terms of the future of institutional activism, the significance of the Tace case is doubted. Tace was a relatively small company with sales of only £36 millions. Further Norwich Union only became involved at the bequest of the Bank of England. The Norwich Union coalition was a relatively small one and even then the difficulties of maintaining it were considerable. It is difficult to envisage a successful coalition that could challenge the management of a major firm, such as General Motors, who, in 2000, had a revenue of over $189 billions.[83]

In the same year, another acrimonious battle commenced by institutional investors took place in which the CEO of Brown & Jackson, a large British discount retailing chain, was removed.[84] The cause of the institution's condemnation was a combination of poor performance and a disastrous 1988 acquisition of a business from a group that included the ousted CEO. At first, the institutions demanded the resignations of the entire board, but soon reduced their demands to a new CEO, to be picked by the outgoing CEO but who would be required to leave if a new financial advisor requested that he do so.

This contest was less bitter and less costly than the Tace battle simply because the institutions did not carry the battle to the bitter end, but were instead prepared to compromise. However, like the Tace battle, the institutions did not escape criticism for publicly voicing their disenchantment. The lead institution was Fidelity Investments Ltd., a subsidiary of Fidelity Group, the largest U.S. mutual fund group. Maybe because Fidelity was foreign-owned it felt less constrained in voicing its disapproval. Nevertheless, not long after the resignation of Brown & Jackson s CEO, Fidelity s chief corporate governance advisor, Alistair Blair was sacked because it

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Financial Times May 4th at 10; R. Gourlay, *Tace Board Quits at Angry EGM* (1991) *Financial Times* June 20th at 23 and N. Cohen, *Getting Directors on Board* (1992) *Financial Times* April 6th at 12.

83 The exact figure was $189,058,000,000. See Fortune Magazine, *The Fortune 1000 List* [Online] Available http://www.fortune.com/fortune/fortune500/ 18th September 2000.

84 For piecemeal accounts, see N. Cohen, *New Advisor at Brown & Jackson* (1991) *Financial Times* October 23rd at 24; N. Bennett, *Brown & Jackson to Seek Rescue Approval* (1992) *The Times* June 15th 2 (Business) at 20; A. Blair, *A Coalition Versus a Dictator* (1992) *Financial Times* May 27th at 13 and N. Cohen, *Tough Tactics Behind the Unit Trusts* (1992) *Financial Times* August 5th at 15.

was felt by [Fidelity s] marketing men that such activity drew too much attention to Fidelity s investment failures. [85]

The final and perhaps most publicised contest concerned a 1993 campaign led by Prudential to install new management in Spring Ram.[86] Spring Ram s founder and CEO Bill Rooney, who owned 16% of the stock, had made a number of poor business decisions by pursuing new ventures in a recessionary climate. He urged the accountants to report good news which led to the accountants resigning and one division to falsify numbers. Eventually, these events surfaced and Prudential and other institutions informally urged Spring Ram to find a new CEO. However, Rooney s handpicked board rebuffed Prudential s advice. The institutions were temporarily placated when Spring Ram appointed a new finance director with strong ties to Prudential. However, after further poor earnings reports, Prudential decided that Rooney had to go.

Rooney continued to resist but Prudential was able to amass the support of a dozen institutions, collectively holding about 35% of Spring Ram s stock and the board conceded. A new CEO chosen by Prudential was installed, together with a majority of new directors.

These episodes demonstrate that when united institutions can make a difference, but it is often at a cost. The Brown & Jackson contest took a year or more to unfold, during which time the share prices declined steadily. [87] The acrimony surrounding the Tace affair continued for a year after the management was ousted, with similar detrimental effects on the share price; the Spring Ram ouster took over six months. In 1993, IBM s CEO was forced to resign. It was heralded as an example of institutional activism. However, the only real change that occurred was the corporation gained an annual loss of $5 billions and the stock price of its shares was halved for the next six

[85] T. Blackstone, *Fidelity Group Goes Mad on Media* (1992) *Evening Standard* May 1[st] at 35. Alistair Blair said himself [b]eware your own chief executive. Does it look wise, from where he sits, to put your firm in the spotlight? See A. Blair, *A Coalition Versus a Dictator* (1992) *Financial Times* May 27[th] at 13.

[86] For piecemeal accounts, see A. Bolger, *Hostages to Declining Housing Market Fortunes* (1993) *Financial Times* September 23[rd] at 20; A. Bolger, *Rooney s Future Remains Unclear* (1993) *Financial Times* July 15[th] at 22; P. Weever & T. Amoore, *Corporate Assassins: Poor Performers Beware, the Institutions are Gunning For You* (1993) *Sunday Telegraph* October 17[th] City Section at 5.

[87] See A. Blair, *A Coalition Versus a Dictator* (1992) *Financial Times* May 27[th] at 13.

months.[88] Similarly, by the time Maurice Saatchi had been pressured into resigning, the company s share price had fallen 98% against the market.[89]

However, financial losses due to increased activism of the kind described above are not the only factors inhibiting institutional activism, and it is these other inhibiting factors that must now be considered.

Barriers to Effective Activism.

The concentration of institutional share ownership and the above examples give the impression that through institutional shareholders we may be on the brink of a new era of corporate accountability. As one commentator has said:

> the holdings of these institutions are now so large that a manageable number of funds could feasibly join hands to supervise managers in a new system of control. [90]

Experience, however, has shown this not to be the case. Possible reasons for institutional passivity, such as the effect on the share price, have already been touched upon. When institutions are active, they try to do so as part of a coalition of other institutions. However, forming and maintaining a coalition is a difficult task and there exist a number of barriers that most institutions fail to overcome. It has been estimated that in practice an institution will need to line up 10-15% of the company s stock to even be granted a formal meeting with the board.[91] This is why to date institutional activism has not delivered all that it promised.

The first barrier concerns the costs of commencing and maintaining a challenge. As noted earlier, the Tace battle cost the Norwich Union and Framlington £60,000. These two institutions held 20% of Tace s stock; the total institutional opposition was 40% of Tace s stock. Although the remaining 20% agreed to vote with Norwich Union and Framlington, they did not agree to share the costs. This highlights a classic barrier concerning institutional activism.

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[88] R.A.G. Monks & N. Minow, *Corporate Governance*, 1995, Oxford: Blackwell, pp.200-1.
[89] *Saatchi Ousting Shocks Admen* (1994) *Sunday Times* December 18th.
[90] A.F. Conrad, *Beyond Managerialism: Investor Capitalism?* (1988) 22 U. Mich. J. L. Ref. 117 at 119.
[91] A. Blair, *A Coalition Versus A Dictator* (1992) *Financial Times* August 5th, p.13.

The free rider problem is frequently advanced for the failure of increased institutional activism. Governance by institutions is reduced because of the potential of individual institutions to benefit from the actions of others. It is contended that as the benefit of collective action goes to every individual institution irrespective of whether or not the institution shared in the costs of collective action, it follows that, unless the group is small, the collective good will not be provided through market mechanisms or voluntary coalitions.[92] Concerned primarily as we are with large public companies, this can have important ramifications. In such companies, the largest institution will hold at most 5% of the company s stock and in many cases much less. Such companies therefore represent a large group where no single member gets no more than a small share of the benefits of collective action. Accordingly, in such groups, the free rider problem dictates that the incentive to co-operate with other potential beneficiaries disappears. Even when institutional coalitions do form, they are usually small in the number of participants, but large in terms of collective shareholdings.[93]

Related to this is the cost of information. Acquiring information on corporate governance matters can often be costly. Accordingly, a small shareholder will not wish to incur such costs as their chances of affecting any change will be negligible. For such shareholders, apathy will be the rational course.[94] Apathy is also the logical choice for large institutional shareholders. Whilst a large shareholder will have the ability to make a change his problem is different. As other shareholders will be uninformed, the large shareholder will have to pay the costs of informing them. This cost of acquiring and disseminating information could outweigh the prospective benefits from improvements in corporate governance. Therefore, large shareholders will also follow a course of rational apathy. [95]

Of course, before the institutions can even begin to mount a challenge against management, they need to be aware of the business operations of their portfolio

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[92] H. Short & K. Keasey, *Institutional Shareholders and Corporate Governance in the United Kingdom* in K. Keasey, S. Thompson & M. Wright (ed.), *Corporate Governance: Economic, Management and Financial Issues*, 1997, New York: OUP, p.32.
[93] B.S. Black & J.C. Coffee Jnr., *Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation* (1994) 92 Mich. LR. 1997 at 2054.
[94] J.N. Gordon, *The Mandatory Structure of Corporation Law* (1989) 89 Colum. L. Rev. 1549 at 1575.
[95] *Ibid.* at p.1576.

companies. This can only be done through active monitoring of their portfolio companies. However, even the largest insurance companies have small monitoring staffs. For example, Norwich Union, the catalyst in the aforementioned Tace affair and the manager of a £24 billion portfolio, has a full time research staff of 12; before 1986 it had none.[96] Similarly, Prudential, the UK s largest institutional investor, employs only twenty full time professional analysts. Yet these companies hold globally diversified portfolios containing hundreds of both UK and foreign stocks. Such staffing policies are clearly inadequate for effective monitoring. It is also the case that very few pension fund trustees and fund managers have no professional qualifications in finance or investment.[97] Consequently, monitoring tends to focus on those companies who are in most financial peril.

Given the above problems, in many cases, coalitions will not be formed. Usually what will happen is that one or more disgruntled investors will communicate their concerns to the board or to a NED. The board will get the message and will either make changes or the company s financial results will improve, diminishing the need for change. Occasionally, the institutions will get what they want but more commonly the outcome will be a compromise. The institutions willingness to compromise indicates their uncertainty over the best course of action, the difficulties of maintaining a coalition and their reluctance to make their concerns public.[98]

A second barrier to institutional activism concerns the potential for conflicts of interest. For example, pension fund managers are usually affiliated with merchant banking firms. If the parent merchant bank represents a company in the fund manager s portfolio or a firm involved in a takeover bid for that company, an actual or potential conflict of interest exists. Fund managers are always seeking new corporate business. A reputation as a troublemaker is to be avoided if new corporate clients are

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96 B.S. Black & J.C. Coffee Jnr., *Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation* (1994) 92 Mich. LR. 1997 at 2068

97 See P. Myners, *Institutional Investment in the United Kingdom: A Review*, 2001, London, p.5. Although there is evidence that fund managers are becoming more qualified with almost 2000 people registering for the Chartered Financial Analyst examination in 2001.

98 B.S. Black & J.C. Coffee Jnr., *Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation* (1994) 92 Mich. LR. 1997 at 2050.

to be gained. As one banker said, a merchant bank s optimum public profile is below the level of the floor.[99]

One commentator has presented three different hypotheses that aim to explain the relationship between institutions and their potential to intervene in corporate affairs.[100] The efficient monitoring hypothesis states that institutional investors are more informed and able to monitor management at a lower cost than smaller shareholders.[101] The strategic alignment hypothesis suggests that institutional shareholders and management may find it mutually advantageous to occasionally co-operate.[102] Finally, and more importantly for our purposes, the conflict of interest hypothesis suggests that institutional investors may have current or potential business relationships with firms that they hold shares in, which will make them less willing to oppose management.[103] Fund managers who develop an anti-manager reputation will lose business and find it harder to attract new clients, *e.g.* several companies withdrew pension fund assets from Tiger management when Tiger ran a proxy contest for representation on the Cleveland-Cliffs board, despite Tiger s strong performance record.[104] Such conflicts may lead some institutions to vote pro-manager even when doing so is likely to decrease company value.

A third barrier to institutional activism concerns the company s desire for soft information. Institutions who oppose management risk cutting themselves off from this flow of soft information that management provides. Whilst the magnitude of this problem is difficult to assess, there is some evidence that institutions that publicly chastise companies they invest in may be denied further information.[105]

Here, there is again evidence of the trade-off between exit and voice. Institutions desire soft information so that they can outperform the market *e.g.* if the soft information suggests a downturn in profits that the market is not aware of, then the

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[99] P. Weever & T. Amoore, *Corporate Assassins: Poor Performers Beware, the Institutions are Gunning For You* (1993) *Sunday Telegraph* October 17th City Section at 5
[100] J. Pound, *Proxy Contests and the Efficiency of Shareholder Oversight* (1988) 20 J.Fin.Econ. 237.
[101] *Ibid.*
[102] *Ibid.*
[103] *Ibid.*
[104] B.S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice* (1992) 39 UCLA. L. Rev. 811 at 826.
[105] See D. Galant, *The Hazards of Negative Research Reports* (1990) *Institutional Investor* July 73.

institution will be able to stay one step ahead of the market by selling its shares. It has been argued that it is highly questionable that institutions can actually outperform the market.[106] However, there now appears to be no doubt that if an institution is in possession of truly material non-public information, then it can make abnormal returns even in an efficient market.[107] Further, where markets are highly competitive, this ability to outperform the market and consequentially to out perform competitors could lead to an increase in investors.

The final barrier concerns the unfettered nature of the shareholder s voting power. A shareholder may cast their vote as they think fit. A vote is regarded as a property right and the shareholder will not be deprived of that right simply because the court disapproves of the motive influencing its exercise.[108] Further, a director who is also a shareholder is not constrained by his directorial fiduciary duties when voting *qua* shareholder.[109]

Just as a shareholder is not required to vote in any particular way, they are not required to vote at all. A shareholder can legitimately, be totally passive in respect of his investment or, as Lord Lowry stated the shareholder may lock away his paid up shares and go to sleep. [110] However, whilst shareholders are not required to vote as a matter of company law, for institutional shareholders, there is the added issue of accountability to their clients. Given this, there is a growing acceptance in practice, although not yet in law, that the obligations of institutional shareholders extend to exercising their voting rights in respect of shares in their portfolio. The issue here is to what extent do institutional shareholders exercise their voting rights.

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106 See M.C. Jensen, *The Performance of Mutual Funds in the Period 1945-1964* (1968) 23 J. Fin. 389 who found that mutual fund returns, a traditionally highly competitive market, were no better than those of a passive investor holding a market portfolio.

107 See N.E. Mains, *Risk, The Pricing of Capital Assets, and the Evaluation of Investment Portfolios: Comment* (1977) 50 J. Bus. 371 at 384. See also J.N. Gordon & L.A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research* (1985) 60 N.Y.U. L. Rev. 761 at 839-41 who argue that this ability to outperform the market casts doubt upon the validity of the Capital Asset Pricing Model.

108 *Pender v Lushington* (1877) 6 Ch.D. 70; *Carruth v Imperial Chemical Industries Ltd.* [1937] AC 707.

109 *North West Transportation Company Ltd. v Beatty* (1887) 12 AC 589; *Northern Counties Securities Ltd. v Jackson & Steeple Ltd.* [1974] 1 WLR 1133.

110 *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd.* [1991] 1 AC 187.

An ABI survey on Voting by Institutional Shareholders, published in July 1991, stated that whilst insurance companies normally voted, practice amongst pension funds was more uneven, with over 20% of them saying that they never voted. A similar survey published by the NAPF in November 1995 indicated some increase in voting by pension funds, although 20% still stated that they never voted. This passivity amongst major groups of institutional shareholders became a target for criticism during the 1990 s and the view that institutional shareholders, as responsible investors, should vote gained ground.[111]

Taking the lead from the USA where pension funds are required to vote as a matter of law, some commentators have argued that the government should impose mandatory voting obligations upon institutional shareholders to counteract the economically detrimental effects of institutional investors behaving as absentee landlords who are happy to collect rent in the form of dividends but who do not seek to monitor management with the result that sub-optimal managerial performance goes unchecked. [112]

However, there are strong arguments against mandatory voting. It could result in box ticking by institutional shareholders — that is routinely supporting management without considering the merits of their decisions. This would not be a positive step forward and could serve to swamp genuinely active monitors who would find themselves outvoted. Also policing mandatory voting would be extremely difficult.[113] The alternative to statutory regulation is therefore self-regulation and whilst self-regulation is perceived to be working, legislative reform is unlikely.[114]

That institutional shareholders should vote has now become an established aspect of good corporate governance. The Combined Code specifically states that

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[111] Institutional Shareholders Committee, *The Responsibilities of Institutional Shareholders in the UK*, December 1991, London: ISC, paras. 3.1-3.3; *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd. para. 6.11; *The Report of the Committee on Corporate Governance*, 1998, London: Gee Publishing Ltd., paras. 5.7-5.9; *The Combined Code: Principles of Good Governance and Code of Best Practice*, 1998, London: FSA, para. E.

[112] E. Ferran, *Company Law and Corporate Finance*, 1999, Oxford: OUP, p.248.

[113] The mandatory voting system in the US has been criticised precisely on this ground and led to accusations that it is basically a form of window dressing: see G.P. Stapledon, *Institutional Shareholders and Corporate Governance*, 1996, Oxford: Clarendon Press, pp.285-8.

[114] The Company Law Reform Steering Group, *Modern Company Law for a Competitive Economy*, March 1998, London: DTI, para. 3.7.

[i]nstitutional shareholders have a responsibility to make considered use of their votes. [115] Both the ABI and the NAPF have begun to actively encourage their members to participate in proxy votes at company meetings and, to counteract the problem of box ticking, established voting information services to assist them in doing so. Through these services, the ABI and the NAPF provide their members with guidance whether the matters which are proposed comply with corporate governance best practices. A similar service is provided by Pensions Investment Research Consultants (PIRC). However, whilst this has resulted in some improvements, surveys indicate that there still remains a considerable gap between these initiatives and the voting behaviour of pension fund managers in practice.[116] This gap between intention and practice has been recognised in the Combined Code which states that institutions should take steps to ensure that their voting intentions are being translated into practice.[117] Recently, the NAPF has gone one step further and advocated that regular considered voting should be regarded as a fiduciary responsibility. [118] In advocating a quasi-mandatory voting regime, the NAPF has obviously been influenced by the position in America. There private pension funds[119] are mandated to vote by the Department of Labor s regulations governing proxy voting by Employee Retirement Income Security Act (ERISA) funds. Due to this requirement, the late 1980s/early 1990s saw firms averaging 80-90% voting levels,[120] with recent voting levels being placed at 83%.[121]

There is evidence to indicate that voting levels are increasing. The Myners Report found that 1999 voting levels had risen to 50% as compared to 20% in 1990.[122] However, this figure needs to be higher. Rather than advocate mandatory voting, which as we saw earlier is problematic, the Myners Report recommends making it a

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[115] *The Combined Code: Principles of Good Governance and Code of Best Practice*, principle E.1, appended to Financial Services Authority, *The Listing Rules*, 2000, London: FSA.
[116] See *Cadbury Fails to Shift Voting* (1997) *Guardian* 25th March reporting the results of a survey by PIRC indicating that the average vote for annual general meetings stood at 39%.
[117] *The Combined Code: Principles of Good Governance and Code of Best Practice*, para. E.1.3, appended to Financial Services Authority, *The Listing Rules*, 2000, London: FSA.
[118] NAPF, *NAPF Enquiry Into UK Vote Execution*, 1999, London: NAPF.
[119] Public pension funds are outside the scope of ERISA, yet many major funds such as the California Public Employees Retirement System (CalPERS), the New York City Employees Retirement System (NYCERS) and the State of Wisconsin Investment Board (SWIB) all have a policy of using their shares.
[120] C. Mallin, *Institutional Investors and Voting Practices: An International Comparison* (2001) 9 Corporate Governance: An International Review 118 at 125.
[121] *Ibid.*

legal duty to vote when it is appropriate to do so.[123] In recommending this, they advocate adopting the principles stated in the US Department of Labor Interpretive Bulletin, in particular the principle that [t]he fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan s investment. [124]

The Future of Institutional Activism.

Accordingly, there is not much to indicate that the increased concentration of institutional share ownership is indicative of a new era of shareholder activism. As one investment manager has stated:

> any conceivable interest in [institutional] activity will not amount to a major new element of accountability in our system matching that of the bank-based economies, since share ownership unaccompanied by the additional involvement in providing finance and other services will never provide the depth of knowledge and commitment that arises with the combination of banking and proprietary interests. [125]

The comparison with bank-based economies, such as Germany and Japan, is a legitimate one. A common feature of these two countries is that banks closely monitor companies, and will intervene where necessary. In Japan, many companies follow a structure known as the *keiretsu*.[126] The structure of a *keiretsu* typically consists of a group of companies clustered around a main bank. This structure allows banks to evade s.11 of Japan s Anti-Monopoly Act,[127] an Act passed by the American occupational forces to prevent concentrations of economic power. This restriction failed. Such *keiretsu s* now hold around 65-70% of all the shares in the Tokyo Stock Exchange.[128] In Germany, bank domination does not result from outright ownership.[129] Rather, German banks hold control because they provide the

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[122] P. Myners, *Institutional Investment in the United Kingdom: A Review*, 2001, London, para.5.84.
[123] *Ibid.* at para.5.90.
[124] *Interpretive Bulletin Relating to Statements of Investment Policy, Including Proxy Voting Policy or Guidelines*, Code of Federal Regulations Table 29 Chapter XXV, 2509. 94-2, 1994.
[125] R.E. Artus (Group Chief Investment Manager of Prudential Corporation plc.) in National Association of Pension Funds, *Creative Tension*, 1990, London: NAPF, p.14.
[126] The word keiretsu is derived from the words *kei* meaning faction or group and *retsu* meaning arranged in order.
[127] *Shiteki dokusen no kinshi oyobi kosei torihiki no kakuho ni kansuru horitsu* (An Act regarding the prohibition of private monopolies and the maintenance of fair trade), 11(a), Law No.54 of 1947.
[128] A. Viner, *Inside Japanese Financial Markets*, 1988, p.56.
[129] Of the largest one hundred German corporations, the banks hold less than 5% of each company s stock. See J. Cable, *Capital Market Information and Industrial Performance: The Role of West German Banks* (1985) 95 Econ. J. 118 at 120.

country s stockbrokerage services, and shares in German corporations are generally deposited by their owners with the banks, who can then exercise the voting rights attached to the shares. Further, by virtue of their representation on the supervisory board, the banks enjoy a formal channel for intervention.[130] In these countries it can therefore be seen that the bank, as the main financial institution, exercises a strong ownership function with a view to securing the long-term stability of the firms within which they invest.

In contrast, banks in the UK have a much more limited role. As of 31st December 2000, banks held only 1.4% of UK equities.[131] Other financial institutions, although holding considerable stock portfolio s, view their shares as investments rather than a means of securing corporate long-term prosperity and shareholder accountability:

> Despite the size of their holdings in industry, the institutions still look upon them primarily as investments, to be bought or sold according to investment criteria; the financial institutions have their own businesses to run (of providing insurance cover, etc.) and neither wish nor need to be involved in managing the businesses in which they invest. [132]

Accordingly, a criticism commonly levelled at institutional shareholding is that it concerned only with short-term profitability, and not the long-term health of the company. An increase in corporate accountability, be it the election of independent directors or an increase in institutional voice, will seldom, if ever, increase profits in the short run. Therefore, for a short-term trader who intends to hold shares only for a short time, the benefits of increased accountability means little whilst the costs of attaining it will be very real indeed. It has been contended that the competition between institutions exacerbates this short-termist outlook. Many institutions are in direct competition for investor funds. If their profitability lags for even a quarter, the investors may withdraw their funds and move them to a competing firm.[133]

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[130] The three main banks (Deutsche Bank, Dresdner Bank and Commerzbank) have such influence that one commentator has noted that they are often regarded as a super-supervisory board of the supervisory boards of industrial concerns. See E.J. Horn, *Management of Industrial Change in Germany*, 1982, Brighton: Sussex European Research Centre, p.40.

[131] Office for National Statistics, *Share Ownership: A Report on the Ownership of Shares at 31st of December 2000*, 2001, London: HMSO, p.8, Table A.

[132] S.J. Prais, *The Evolution of Giant Firms in Britain*, 1976, Cambridge: Cambridge University Press, p.114.

[133] J.C. Coffee Jnr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor* (1991) 91 Colum. L. Rev. 1277 at 1325.

Therefore, while fund managers are still held accountable in terms of monthly or quarterly performance and the benefits of improved corporate governance are not realised over this period, which they will not be, they will understandably be reluctant to incur costs that do not improve their overall position in relation to their competitors.

It is, however, contended that the short-term nature of institutional holdings has been exaggerated, if not misunderstood. It has been contended that pension funds (22.1% of market) and insurance companies (23.5%) have acquired their strong positions as equity holders because they are in fact instruments for long-term saving.[134] The Myners Report stated that the average holding period for any given share in a pension fund portfolio is over 8 years.[135]

Concerning insurance companies, their strong position derives from their position as providers of life insurance. Although life insurers were traditionally concerned to provide an income to their dependants after their death, today life insurance is often used as an instrument for pure saving over long periods *e.g.* 10, 20 or 25 years. Likewise, pension funds are clearly instruments of long-term saving. The typical occupational pension scheme consists of a fund to which both the employer and the employee make defined contributions over a significant period of time.

Further evidence for the contention that institutions are long-term can be derived from those firms that engage in R&D. R&D is a quintessentially long-term investment. Yet: (i) stock prices react favourably, on average, to increased R&D spending[136] and (ii) if institutional investors are more myopic than other investors, they should own a lower percentage of investment in R&D intensive firms, but institutions hold higher stakes in such firms.[137]

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[134] P.L. Davies, *Institutional Investors in the United Kingdom* in T. Baums, R.M. Buxbaum & K.J. Hopt (eds.), *Institutional Investors and Corporate Governance*, 1994, Berlin; New York: de Gruyter, p.258. See also H.T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment* (1990) 38 UCLA. L. Rev. 277 who argues that institutions are not systematically myopic.

[135] *Developing a Winning Partnership: How Companies and Institutional Investors are Working Together*, September 1996, London: DTI, p.6.

[136] F. Woolridge, *Competitive Decline and Corporate Restructuring: Is a Myopic Stock Market to Blame?* (1988) Continental Bank J. Applied Corp. Fin. 26 at 33-4.

[137] Jones, Lehn & Mulherin, *Institutional Ownership of Equity: Effects on Stock Market Liquidity and Corporate Long-Term Investments* in A. Sametz & J. Bicksler (eds.), *Institutional Investing: Challenges and Responsibilities of the 21st Century*, 1991, pp.115 at 123-4.

Conclusion.

As noted, the governance work of institutional investors takes place behind the scenes and so its impact is difficult to assess. In 1991, testifying before the House of Commons, Michael Sandland, the then chairman of the Institutional Shareholders Committee, was asked how often institutions use the threat of coalition action to remove the board or an inefficient director. He answered that he did not know what other institutions were doing, but when pressed to estimate how often his own firm had engaged in such a threat, he responded:

> We saw over the last year there have been two, possibly three, confrontations which have reached public notice. As to the numbers of serious or possibly robust discussions which have not surfaced in the press or wider public I find it very difficult, maybe a dozen. [138]

Despite this, we have seen that there is evidence suggesting that institutional activism is not uncommon. However, when activism is present, it is usually crisis-driven. The largest insurance firms — Prudential, Norwich Union and Legal & General — and a few large unit trusts, such as M&G, engage in regular proactive monitoring and do lobby for governance changes when their portfolio companies are not in crisis. However, as we have seen, they have limited resources and so focus their attention of poorly performing companies. Accordingly, companies performing adequately and above can resist corporate governance reforms with little fear of institutional intervention.[139]

III. BOARD REFORM

The Composition of UK Boards.

A leading academic has stated that [a] widely held sentiment is that all is not well with the way UK companies are run. [140] The fact that British firms appear to have been losing ground to other firms on the world stage lends support to this, as does the collapse of a number of prominent companies and allegations of severe misconduct against their CEOs. Many agree that the source of these problems lies at the apex of the corporate hierarchy, the board of directors. In response to the increasing criticism

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[138] Trade and Industry Committee, House of Commons, *Takeovers and Mergers: Minutes of Evidence, 1990-91*, 1991, Sess. 278, quoting the testimony of Michael Sandland of Norwich Union.

[139] B.S. Black & J.C. Coffee, *Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation* (1994) 92 Mich. LR. 1997 at 2053.

[140] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.602.

aimed at the detriments of unbridled corporate power has come a wealth of suggestions aimed at limiting the power of directors through changes in corporate structure. Governmental or legislative constraints have not been entirely abandoned, but a major effort has been made to internalise the corrective process via the monitoring of the board. As the European Commission pointed out:

> legislators in many Member States have attempted to solve the problem of supervision by introducing into the company s structure a new element: a body distinct from either the general meeting or the managing board or council which has as its function the supervision and control on behalf of the shareholders of those managing the company. [141]

Of all the structural reforms, few have such broad support as the notion of the non-executive director (NED).[142] It has been contended that the recent reliance on NEDs is a market-induced mechanism to limit agency costs in compliance with widely dispersed shares. [143] There is no legal requirement for companies to appoint non-executives. Indeed, statute does not recognise any distinction between executives and non-executives. The theoretical advantages of NEDs as monitors of the board are easy to see. As NEDs are generally not involved in the actual running of the business, they seem perfectly able to assess the company s performance, and that of management, from a more neutral standpoint.[144] NEDs are now common amongst large companies[145] and are becoming an increasing numerical force on the board:

Table 5.1: Composition of Boards of Quoted UK Industrial Companies 1979-93.[146]

	1979	1982	1985	1988	1993
Average proportion of non-executive directors	30%	33%	35%	38%	44%

[141] *Employee Participation and the Company Structure in the European Community* (1975) Bull/Supp. 8/75 at 18.

[142] On the history and evolution of NEDs, see J. Parkinson, *Evolution and Policy in Company Law: The Non-Executive Director* in J. Parkinson, A. Gamble & G. Kelly (eds.), *The Political Economy of the Company*, 2000, Oxford: Hart Publishing, pp.246-57.

[143] J. Parkinson, *Evolution and Policy in Company Law: The Non-Executive Director* in J. Parkinson, A. Gamble & G. Kelly (eds.), *The Political Economy of the Company*, 2000, Oxford: Hart Publishing, p.234.

[144] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.192.

[145] Over 95% of the top 200 companies now have at least one NED: see Institute of Chartered Accountants for England and Wales, *Report of the Study Group on the Change in the Role of the Non-Executive Director*, 1991, London: ICAEW, p.8.

[146] For 1979 and 1982, see Bank of England, *The Composition of Company Boards in 1982* (1983) 23 Bank Eng. Q. Bull. 66 at 68. For 1985, see Bank of England, *The Boards of Quoted Companies* (1985) 25 Bank Eng. Q. Bull. 233 at 235 (Table D). For 1988 and 1993, see M.J. Conyon, *Corporate Governance Changes in UK Companies Between 1988 and 1993* (1994) 2 Corp. Gov.: Inter. Rev. 97 at 103 (Table 2).

As can be seen, there has been a steady increase in the proportion of NEDs on boards during this period. However, even in 1993, the average board of a quoted industrial company still had only a minority of NEDs. Indeed in 1985, only 22% of quoted industrial companies had a board with a majority of NEDs;[147] by 1993 this figure was only 25% (although a further 24% of companies had a board with equal numbers of executives and non-executives).[148]

Figures however, are not consistent. Given this, and the fact that Table 5.1 concerned only industrial companies, Stapledon carried out a study for the years 1971, 1981 and 1991.

Further to Table 5.2, NEDs were in a majority on the boards of 92% of financial companies in the 1971 sample; at 92% of the financial companies in the 1981 sample, and at 94% of the financial companies in the 1991 sample.[149] Concerning industrial companies, non-executives were in the majority in a mere 10% of the 1971 sample; at 17% of the 1981 sample, and at 27% of the 1991 sample.[150] It is therefore clear that NEDs are more numerous in financial companies as the following table suggests:

Table 5.2: Composition of Boards of Large UK Listed Companies 1971-91.[151]

	Average % of non-executive directors		
	1971	1981	1991
All companies	42	45	48
Financial companies	76	72	66
Industrial companies	31	36	43

Cadbury and the Non-Executive Director.

UK boards have always contained directors who have been part-time and without executive office, be it the six-month old Marquis of Bute in <u>Re Cardiff Savings</u>

[147] Bank of England, *The Boards of Quoted Companies* (1985) 25 Bank Eng. Q. Bull. 233 at 235 (Table C).
[148] G.P. Stapledon, *Institutional Shareholders and Corporate Governance*, 1996, Oxford: Clarendon Press, p.140.
[149] *Ibid.*
[150] *Ibid.*
[151] *Ibid.* at p.141.

Bank[152] or the country gentleman of Re Denham & Co.[153] Such directors were often employed simply to allow the company to be associated with a person of their reputation and distinction.[154] However, only recently has the resurgence of NEDs has acquired a new importance since the Cadbury Report,[155] which was subsequently described by the Hampel Committee as a landmark in thinking on corporate governance. [156]

Cadbury s central recommendation was that the boards of all listed companies registered in the UK should comply with a Code of Best Practice.[157] The Committee also recommended that any reasons for non-compliance should be set out in the company s reports.[158] The Code of Best Practice was widely welcomed upon its publication and the statement of compliance was made a continuing obligation of listing by the Stock Exchange, the task having now been taken over by the Financial Services Authority.[159]

The main thrust of Cadbury relates to NEDs.[160] According to Cadbury, they should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct. [161] To this end, there should be a minimum of three NEDs on the board.[162] The Combined Code has

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152 [1892] 2 Ch. 100.
153 (1883) 25 Ch.D. 752.
154 The notorious *Times* advertisement for A titled person required to add distinction to the board of a wine company. No responsibility, investment or participation required-firm very sound. encapsulates this antiquated view of the non-executive director s role.
155 *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd.
156 *The Report of the Committee on Corporate Governance*, 1998, London: Gee Publishing Ltd., para. 1.5.
157 *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para. 3.1.
158 *Ibid.* at para. 3.7.
159 See Financial Services Authority, *The Listing Rules*, May 2000, London: FSA, para. 12.43A.
160 V. Finch, *Board Performance and Cadbury on Corporate Governance* [1992] JBL 581 at 591.
161 *The Code of Best Practice*, 1992, London: Gee Publishing Ltd., para. 2.1.
162 *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para. 4.11. By 1999, 93% of companies were complying with this requirement: see Pensions & Investment Research Consultants Ltd., *Compliance With the Combined Code: A Study Prepared for the Company Law Review*, September 1999, [Online] Available 28th March 2000 http://www.dti.gov.uk/cld/pirc.pdf., p.8.

since argued that in order for NEDs to be able to carry significant weight in the board s decisions, NEDs should compromise no less that one-third of the board.[163]

The key to this aim lay in the NEDs being independent. On this, the Code states that NEDs should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.[164] They should be appointed for specific terms and reappointment should not be automatic.[165]

The attraction of board-level monitoring is convincing at first when compared to other governance mechanisms. Unlike shareholders, NEDs, at least in theory, have unlimited access to company information. Monitoring at board-level will also avoid the problems of collective action that plague other governance arrangements. Finally, board-level monitoring is less costly than other forms of governance, notably the market for corporate control. One could even argue that effective board level monitoring would render the market for corporate control obsolete as a truly independent board would not tolerate suboptimal managerial performance.[166] However, as we shall see, NEDs suffer from several serious limitations which make it extremely difficult for them to effectively carry out their monitoring function.

There has also been strong criticism of the Cadbury Report. Several commentators have argued that the recommendations are too vague and should have been more explicitly delineated.[167] Others argue that Cadbury s recommendations are not ambitious enough and do not go far enough to give the NEDs a serious monitoring role.[168]

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[163] Committee on Corporate Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice*, para.A.3.1 appended to Financial Services Authority, *The Listing Rules*, May 2000, London: FSA.
[164] *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para. 4.12.
[165] *Ibid.* at para. 4.16.
[166] J.C. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer s Role in Corporate Governance* (1984) 84 Colum.L.Rev. 1145 at 1203.
[167] See *e.g.* J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, pp.193-4.

However, there is also evidence to indicate that Cadbury has strengthened the position of NEDs. NEDs are now able to use Cadbury as a yardstick. If companies do not comply, the NEDs can state that unless change is forthcoming they will communicate their concerns to the institutional investors. Hence, as one member of the Cadbury Committee stated in 1995 Cadbury has provided the conscientious non-executive director with a bannister to hold on to in the face of a dominant chief executive. [169] Further, since Cadbury, there is evidence that NEDs have been taking their role more seriously. A 1991-94 study discovered a spectacular productivity increase in the output of NEDs with the amount of time that they spent working for their company increasing 50% without any increase in pay.[170] The indications are that this workload will increase even further as companies make even more use of their NEDs in the future.[171]

However, it has to be acknowledged that, despite the above, the impact of Cadbury was always going to be limited. A 1994 study of 200 of the UK s largest listed companies found that only half had corporate governance structures in place that fully complied with the Cadbury Code of Best Practice.[172] Full compliance was even less common in small and medium-sized listed companies.[173]

There is little doubt that Cadbury has had an impact on the role of directors in UK listed companies. It is probably still too early to tell whether or not the impact will be positive and long-term but for the time being, the Cadbury guidelines seem to be operating in the manner that the Report envisaged. Perhaps even more significant,

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[168] See *e.g.* N.G. Maw *et al*, *Maw on Corporate Governance*, 1994, Aldershot: Dartmouth, ch.13; P.L. Davies, *Institutional Investors in the United Kingdom* in D.D. Prentice and P.R.J. Holland (eds.), *Contemporary Issues in Corporate Governance*, 1993, Oxford: Clarendon Press, pp.93-4.

[169] See *Sorting Out Son of Cadbury* (1995) *Times* 26th January, p.24.

[170] See *Outside Directors More Productive* (1994) *Financial Times* 17th October (discussing research carried out by 3i, a large investment company.) Later studies, however, indicate that NED remuneration is starting to rise to reflect their increased workload: *Non-Executive Fees Rise Along with Extra Responsibility* (1996) *Times* 13th May.

[171] PRO-NED, *Chairmen and Non-Executive Directors: Fees, Facts and Attitudes*, 1994, London: PRO-NED, pp.26-7.

[172] See *e.g. Half of UK Companies Fail Corporate Governance Code* (1995) *Financial Times* 23rd January (research by PIRC); *Boardroom Code Largely Ignored* (1994) *Daily Telegraph* 25th February (research by NAPF.)

[173] See *e.g. Smaller Firms Too Slow on Non-Execs* (1995) *Times* 6th March; *Half a Revolution* (1995) *Economist* 27th May and A. Belcher, *Compliance with the Cadbury Code and the Reporting of Corporate Governance* (1996) 17 Co.Law. 11 at 14, 17.

Cadbury went a long way toward establishing the current trend of self-regulation that is becoming increasingly important in UK corporate governance.

The Role of Non-Executive Directors.

As noted, there have long been directors without executive office. However, our law does not reflect this as the Companies Act 1985 refers only to directors: it does not differentiate between executive and non-executive directors. Whilst all directors have the same legal duties[174] and statutory responsibilities, the very existence of NEDs implies that their role is in some way different to that of their executive counterparts.

It is widely accepted that the boards of virtually all large public companies do not manage their companies day-to-day business.[175] Rather their role has been referred to as one of direction and control of the company. [176] It is this control or monitoring function that concerns us here as it is this function that distinguishes the roles of executive and non-executive directors: executive directors are responsible (as managers) for activities which it is the duty of the board as a whole to monitor This means that the nature of the monitoring role is *ipso facto* different for non-executive directors. [177] Accordingly:

> Non-executive directors have two particularly important contributions to make to the governance process as a consequence of their independence from executive responsibility The first is in reviewing the performance of the board and of the executive The second is in taking the lead where potential conflicts of interest arise. [178]

During the 1980 s and 1990 s, structural support for the second of these functions was given by the introduction of audit, remuneration and nomination committees.[179] However, the monitoring function has not been as successful.

[174] See Dorchester Finance Co.Ltd. v Stebbing [1989] BCLC 498, where Foster J held that [i]n the Companies Act 1948 the duties of a director whether executive or not are the same. The same is true of the Companies Act 1985. See *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para. 4.3.
[175] G.P. Stapledon, *Institutional Shareholders and Corporate Governance*, 1996, Oxford: Clarendon Press, p.142.
[176] *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para. 1.4.
[177] J.P. Charkham, *Corporate Governance and the Market for Control of Companies*, 1989, London: Economics Division, Bank of England, p.13.
[178] *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., paras. 4.4-4.6.
[179] See M.J. Conyon, *Corporate Governance Changes in UK Companies Between 1988 and 1993* (1994) 2 Corp.Gov.: Inter. Rev. 97.

Barriers to Effective Monitoring.

Firstly, there is ambiguity concerning the role of NEDs, namely are they required solely to monitor the board or are they also required to play an active part in managing the company.

The answer appears to be both.[180] NEDs appear well placed to monitor the board. Further, if the chairman is an executive director, a senior non-executive director should be appointed in order to maintain a balance between the executive and non-executive influence. [181] However, this should not detract from the primary contribution which they are expected to make, as equal board members, to the leadership of the company. [182] However, this creates problems from a monitoring standpoint. As NEDs are required to work with the executives in leading the company, they will in effect be required to an extent to monitor their own conduct.

It has therefore been contended that Cadbury aims to segregate the executives from the non-executives.[183] This will create, if not an implicit two-tier board, then certainly a bifurcated one.[184] In doing this, Cadbury has been criticised for imposing a two-tier board philosophy upon a unitary board structure.[185] Yet it is perceived that the law still refuses to acknowledge any distinction between executive and non-executive directors.

This contention is only partially true. Whilst it is true that the dual role of NEDs creates problems and some segregation will inevitably occur, Cadbury cannot wholly be blamed. Throughout its report, Cadbury was extremely careful to state that executives and non-executives were part of one unified board.[186] However, despite

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[180] See M. Ezzamel & R. Watson, *Wearing Two Hats: The Conflicting Control and Management Roles of Non-Executive Directors* in K. Keasey, S. Thompson & M. Wright (eds.), *Corporate Governance: Economic, Management, and Financial Issues*, 1997, New York: OUP, pp.54-79.
[181] *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para. 4.3.
[182] *Ibid.* at para. 4.7.
[183] V. Finch, *Board Performance and Cadbury on Corporate Governance* [1992] JBL 581 at 592.
[184] J. Sims, *How Two-Tier Boards Can Cut Corporate Confusion* (1992) *Independent on Sunday* December 6th at 24.
[185] Sir O. Green, *Why Cadbury Leaves a Bitter Taste* (1992) *Financial Times* June 9th.
[186] *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., paras. 4.1-4.4.

this, there are still those who contend that Cadbury s proposals have created two distinct classifications of director, the doers and the checkers [187] and the law should reflect this.

Striking the balance between a NED s monitoring and managerial function is important in relation to determining the scope of their legal duty of skill and care. If NEDs are to be primarily viewed as monitors,[188] this opens the way to placing blame upon them for failure to detect and rectify underperformance or abuse by the executive directors. However, it would be much more difficult to lay this blame if their role as managers is emphasised more strongly than their monitoring role.[189]

Perhaps even more worrying from a NED s point of view is the extent of their liability under the CDDA. It now appears that a NED who fails in his role as executive monitor may be disqualified. In Re Continental Assurance Co. of London plc.,[190] an insurance company had gone into liquidation with debts in excess of £8 millions. All three directors of the company were disqualified including a NED. The court accepted that the NED had not known of the executive s misconduct of the company s affairs, in particular the fact that it was lending money to its parent company in breach of s.151 Companies Act 1985. However, the court concluded that any competent director in his position should have known what was going on and that his failure to discover the wrongdoing displayed serious incompetence or neglect and was sufficient to justify disqualification. Accordingly, if a NED can be disqualified for not carrying out his roles properly, surely clarification is needed so that NEDs know what their role is to be.

A second barrier to effective monitoring concerns executive dominance of the board. NEDs are commonly outnumbered by the executive directors. Since they are in the minority and lack the co-operation of management, they are effectively impotent. [191]

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[187] P. Martin, *Taming the Overmighty Boss: The Cadbury Report Hopes to Make UK Companies Better Run, But Will it Make Them More Profitable* (1992) *Financial Times* December 2nd at 20 quoting Peter Morgan of the Institute of Directors.

[188] *The Report of the Committee on Corporate Governance*, 1998, London: Gee Publishing Ltd., para.3.7 stated that Cadbury emphasised the NEDs monitoring role to an unwarranted extent.

[189] E. Ferran, *Company Law and Corporate Finance*, 1999, Oxford: OUP, p.220.

[190] [1996] BCC 888.

[191] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.194.

Not only do executives dominate numerically, but also as full-time executives they have privileged access to and control of internal information. If the executives decide not to disclose key facts, even the most diligent non-executive will find it almost impossible to monitor the executives.[192] Even if non-executives do have access to inside information, they may not be in a position to do anything with it. A typical NED will spend between one or two days a month on company business and this will be spent in the boardroom. This is little time to become conversant with the company s business.[193] NEDs therefore rely on the executives to draw attention to what is important. Accordingly, some distortion is likely to occur.[194] Since the presence of NEDs on the board is seen to be one way of redressing the informational asymmetries that exist between the management of a company and its shareholders,[195] the difficulties that they face with regards to access to management information represents a serious problem.[196]

The final and perhaps most emasculating barrier concerns the NED s independence. Firstly, many NEDs are themselves executive directors of large plc s,[197] a position which produces a heavy workload: indeed it has been suggested that persons who have not experienced the responsibilities of executive directorships would be unsuitable for positions as non-executive directors.[198] This means that (a) they are unlikely to have the time to monitor effectively the companies in question, and; (b) as they are executive directors themselves, they may socialise with or serve on other boards as fellow non-executives with-the executives they are supposed to monitor. Accordingly, it has been noted most outside directors share management s

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[192] A 1994 survey indicates that having insufficient information was a major concern for two out of three non-executive directors: see BDO Binder Hamlyn, *Non-Executive Directors-Watchdogs or Advisors?* p. 5 discussed in *Non-Executives and the Expectation Gap* (1994) Accountancy, September 74.

[193] G. Mills, *On the Board*, 1985, 2nd ed., London: George Allen & Unwin, pp.137-40

[194] A. Demb & F.F. Neubauer, *The Corporate Board: Confronting the Paradoxes*, 1992, New York: OUP, pp.117-23.

[195] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, pp.174-7, 191-9.

[196] M.C. Jensen, *The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems* (1993) 48 Journal of Finance 831 at 864.

[197] In 1993, 54% of non-executives of UK industrial companies were executive directors of other unconnected companies. See Korn/Ferry International, *Boards of Directors Study UK*, 1993, London: Korn Ferry, p.33.

[198] I. Stratton, *Non-Executive Directors: Are They Superfluous?* (1996) 17 Co.Law. 162 at 164. Accordingly, one commentator has suggested that companies seek directors who have a strong record of managing a company, so that they can bring this expertise in their role as non-executive director. See D. Bell, *Setting Pay at the Top* (1994) Incomes Data Services 5 at 9.

ideological disposition toward the single issue most central to their monitoring responsibilities: how intensely outside directors should monitor management. [199] There is also the real possibility that non-executives may pull their punches out of an innate fear of encouraging non-execs on their own boards to rock the boat too often. [200]

The appointment of NEDs is also a cause for concern.[201] In virtually all UK listed companies, the appointment of all NEDs must be confirmed by an ordinary resolution of the general meeting, and they are then subject to periodic re-election by the shareholders.[202] Nevertheless, most NEDs of UK companies are *selected* by the chairman of the board, in many cases because the potential NEDs have a personal acquaintance with the chairman, with the shareholders providing only the official rubber stamp. [203] In 1994, it was stated that 50% of non-executives in UK industrial companies were chosen by the chairman.[204] If the chairman is also the CEO, then a NED may feel compelled to exhibit loyalty to the person who appointed him.[205]

The difficulties posed by managers selecting their own monitors have diminished recently. The Cadbury Committee recognised this problem and recommended that non-executives should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole, [206] and regarded it as a matter of good practice for a nomination committee[207] consisting of a majority of

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199 R.J. Gilson & R.Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors* (1991) 43 Stan. L. Rev. 863 at 875.

200 See *Knives are Out in the Boardroom* (1992) *Financial Times* May 1st at 11.

201 A PRO-NED survey carried out in the early 1990 s discovered that 86% of senior business people and investors were dissatisfied with the appointment process of non-executive directors. See A. Jack, *Cadbury Attacks Old-Boy Network* (1992) *Financial Times* September 28th at 8.

202 This requirement is not legislative but most companies articles will probably contain provisions similar to arts.73-80 Table A; *cf.* the position as regards executive directors.

203 L. Miles and G. Proctor, *Re-Designing the Office of Non-Executive Director: Has the Consultation Document Gone Far Enough?* (2000) 21 BLR 143 at 144.

204 KPMG Peat Marwick, *Survey of Non-Executive Directors*, 1994, London: KPMG, p.12.

205 On the loyalty point, see J.D. Cox & H.L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion* (1985) 48 Law and Contemp. Problems 83 at 91-9.

206 *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para.2.4.

207 By 1999, 78% of companies appointed non-executive directors by a nomination committee: see Pensions & Investment Research Consultants Ltd., *Compliance With the Combined Code: A Study Prepared for the Company Law Review*, September 1999. [Online] Available http://www.dti.gov.uk/cld/pirc.pdf., p.12, 28th March 2000.

NEDs[208] to carry out the selection process and make recommendations to the board.[209] Further, at Cadbury s behest,[210] it has become common practice for companies to split the chairman and CEO roles.[211] However, this by no means ensures transparency and objectivity. In companies with nominating committees, the CEO can often continue to play a significant behind the scenes role in selecting nominees.[212] Where the chairman and the CEO are split, relations between the two are often close. The reason for this is that it is common for the chairman to be the company s former CEO who would have had a strong input as to his successor.[213]

Even if objectivity is secured in the appointment process, there is reason to doubt the motivation NEDs will have for their monitoring function. Part of this problem is that NEDs are often paid considerably less than their executive counterparts and pay is rarely tied to performance. Therefore it has been contended that NEDs have incentives to use their power in a manner that will discourage risk-taking and stifle entrepreneurship.[214] Further, if they are executives for another company, as we have noted they may well be, the fees will be paid to that company rather than the director. Accordingly, from a financial perspective, NEDs have little to gain by being diligent and meticulous.[215] This may explain why in recent years, there has emerged a growing scarcity of non-executive director talent. A 1994 Korn Ferry survey found that the proportion of boards that had been turned down by prospective NEDs had increased from 24.9% in 1989 to 65% in 1993.[216]

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208 At 1999, 79% of companies had nomination committees consisting of a majority of non-executive directors: *Ibid.* at p.13.

209 See Committee on Corporate Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice*, 1998, para. A.5.1 appended to Financial Services Authority, *The Listing Rules*, May 2000, London: FSA.

210 *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para.4.9. *The Report of the Committee on Corporate Governance*, 1998, London: Gee and Co., paras. 3.18-19 felt that Cadbury s recommendation on the separation of roles was too restrictive.

211 In 1999, it was reported that 87% of companies had split the roles of chairman and CEO: see PIRC Ltd., *Compliance With the Combined Code: A Study Prepared for the Company Law Review*, September 1999, [Online] Available http://www.dti.gov.uk/cld /pirc.pdf., p.4, 28th March 2000.

212 B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.609.

213 D. Clutterbuck & P. Waine, *The Independent Board Director*, 1993, London: McGraw-Hill, p.41.

214 B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p. 625.

215 G.W. Dent, *Toward Unifying Ownership and Control in the Public Corporation* [1989] Wisc. L. Rev. 881 at 899.

216 See G.F. Davies, *The Significance of Board Interlocks for Corporate Governance* (1996) 4 Corporate Governance: An International Review 154.

Evidence of Problems.[217]

Critics of NEDs have drawn attention to several instances where executive managers have acted in an imprudent or self-serving manner and assigned blame to those directors who failed to detect or remedy the behaviour in question. One example involved a dirty tricks campaign carried out in the early 1990 s by British Airways plc. against Virgin Atlantic. Many felt that the NEDs should have more closely monitored what Lord King, the CEO and chairman of the board, was doing.[218] Another example concerned the drinks company Guinness plc. In 1986, its bid for Distillers plc. was largely conducted by three of the company s directors, these being the CEO, the finance director and a US lawyer, Mr. Thomas Ward. The bid was highly controversial culminating in a series of criminal trails involving allegations of illegal share price support, conspiracy to defraud and theft.[219] In particular, criticism was levelled at the NEDs for failing to scrutinise what was going on. This was brought to bear when the House of Lords held that Mr. Ward should return to the company £5.2 millions he charged as fees.[220] Finally, in 1987, Blue Arrow plc., an employment agency group, orchestrated a takeover of US-based Manpower inc., then the world s largest employment agency.[221] Two DTI investigations drew attention to the fact that Mr. Tony Berry, the chairman and CEO of Blue Arrow, was allowed to exercise an extremely wide discretion in relation to the company s affairs. The DTI inspectors stated that a balanced board structure was not present and this failure had meant that Blue Arrow s three NEDs did not have the information, time and resources required to monitor Mr. Berry s conduct.

A second set of examples concerns companies that have suffered dramatic financial problems due to the failure of the NEDs to monitor effectively. A common thread within these cases is that these companies are run by a charismatic and public principal character whom the NEDs (and for that matter, the executives) fail to

[217] The following examples are drawn from B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, pp.611-14.
[218] *E.g.* N. MacErlean, *D&O: Do You Need It?* (1993) Accountancy, March 40.
[219] See M. Levi, *The Investigation, Prosecution and Trial of Serious Fraud* (Research Study No. 14 for the Royal Commission on Criminal Justice), 1993, London: HMSO, pp.219-22.
[220] *Guinness PLC v Saunders* [1990] 2 WLR 324. There were also failures to comply with the disclosure requirements contained in s.317 Companies Act 1985. See G. McCormack, *The Guinness Saga: In Tom We Trust* (1991) 12 Co. Law. 90, especially at 91-3.

exercise control over.[222] The most recent and spectacular example concerned press baron Robert Maxwell and two public companies, Maxwell Communications Corporation and Mirror Group Newspapers plc. In 1991, when Mr. Maxwell died, his vast business empire quickly collapsed. It subsequently came to light that the company s pension funds had been siphoned off to support other business interests of Mr. Maxwell and that he had been involved in what was likely an illegal share price support scheme. Both companies contained NEDs, including former politicians. These individuals conferred respectability on Mr. Maxwell, but either did not have the ability or the will to put a stop to his activities.[223]

This has been repeated. In 1990, the food and consumer electronics group, Polly Peck International plc. had shares with a market value of £1.75 billion. Within months however, the equity was worthless and its CEO and chairman, Mr. Asil Nadir, fled the country after being charged with stealing over £100 millions from the company. In 1991, the property and leisure group, Brent Walker plc. collapsed with debts of £1.5 billion following a number of dubious transactions by its CEO Mr. George Walker. And finally, between 1989 and 1993, the hotel management firm Queens Moat Houses plc. suffered a dramatic reduction in share price culminating in a 1992 loss of £1.02 billion. All of these firms collapsed amidst accusations that the NEDs had let the investors down by not making sufficient efforts to stem the company s decline.[224]

Evidence suggests that these are not one-off incidents. A study by Franks, Mayer and Renneboog found that the presence of NEDs on the board was not related to managerial changes when corporate performance was poor.[225] A follow-up study confirms these findings.[226]

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[221] See H. Shilling, *Blue Arrow: Lessons on Corporate Governance* (1993) *PLC*, June 35.
[222] C. Boyd, *Ethics and Corporate Governance: The Issues Raised by the Cadbury Report in the United Kingdom* (1996) 15 J. of Bus. Ethics 167 at 168-9.
[223] P. Stiles and B. Taylor, *Maxwell—The Failure of Corporate Governance* (1993) 1 Corp.Gov.:Inter. Rev. 34 at 40.
[224] T. Sheridan and N. Kendall, *Corporate Governance: An Action Plan for Profitability and Business Success*, 1992, London: Pitman Publishing, p.106; T. Smith, *Accounting for Growth: Stripping the Camouflage from Company Accounts*, 1992, London: Century Business, pp.221-3.
[225] J. Franks, C. Mayer and L. Renneboog, *Who Disciplines Management in Poorly Performing Companies*, 2000.

The above suggests that the monitoring role provided by NEDs is unlikely to be effective, and therefore one would imagine that they would contribute little to corporate performance. If NEDs have indeed evolved as a market-induced mechanism to increase efficiency by monitoring the board, then their failure to monitor would also result in a failure to improve efficiency.

The majority of the available empirical evidence seems to support this. A number of studies show no positive correlation between corporate performance and the presence of NEDs on the board.[227] Indeed, some studies even suggest that the presence of NEDs can have detrimental effects on corporate performance.

Conclusion.

The predicament surrounding the corporate governance potential of non-executive directors has been summed up succinctly thus:

> Non-executives are in general picked by the executives, owe their salary to the executives, and commonly share social and other business connections with the executives. They rely on executives for information and advice, and their principal duties are carried out in the presence of the executives. It is hardly surprising that changes in executive management are more frequently the product of expensive, external action through take over than consequences of the activities of non-executive directors. [228]

Accordingly, the notion that outside directors with little or no equity stake in the company could effectively monitor and discipline the managers who selected them has proven hollow at best. [229] In theory, the concept of the NED is an attractive one.

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[226] S. Letza, P. Hardwick and J. Ashton, *Who Disciplines Management in Poorly Performing Companies? An Updated Study* [Online] Available http://www.dti.gov.uk/cld/bourne.pdf 23rd March 2001.

[227] *E.g.* S. Bhagat and B. Black, *The Relationship Between Board Composition and Firm Performance* in K.J. Hopt *et al*, *Comparative Corporate Governance: The State of the Art and Emerging Research*, 1998, Oxford: OUP, p.281.

[228] E. Davis & J. Kay, *Corporate Governance, Takeovers and the Role of the Non-Executive Director* in M. Bishop & J. Kay (eds.), *European Mergers and Merger Policy*, 1993, Oxford: OUP, p.212. Similar concerns have been voiced in the USA:

> [non-executive directors] are effectively nominated by the CEO, they must rely on the executives for most of the information they receive, and they need good relationships with the officers if they are to function well in guiding corporate policy. Often, directors share similar backgrounds and interests with the firms executives. Frequently, they themselves are senior executives in other firms. Moreover, outside directors who are not CEO s of other firms may well derive a significant portion of their incomes from their directorship.

See P. Milgrom & J. Roberts, *Economics, Organization and Management*, 1992, Eaglewood Cliffs, New Jersey: Prentice-Hall, p.434.

[229] M.C. Jensen, *The Eclipse of the Public Corporation* (1989) Harv. Bus. Rev. (Oct.) 61 at 64.

Prima facie the recommendations of the Cadbury Committee would do much to make that theory a reality. The practical weaknesses of the office however, most notably issues of independence, ensure that NEDs are only likely to be involved in anti-management action when the company is in some sort of crisis. Ultimately, the most significant problem is not the rules or procedures relating to NEDs, but the fact that it is in their best interests not to monitor too critically. One commentator has suggested that most outside directors share management s ideological disposition toward the single issue most central to their monitoring responsibilities: how intensely outside directors *should* monitor management. [230] If ultimately both the executives and non-executives are of the opinion that NEDs should not monitor too closely, no rule or procedure is going to avoid this limitation. The failure of the nomination committee is evidence of this. Until these inherent ideological weaknesses can be removed, the NED will never be able to fulfil his role as envisaged by Cadbury.

IV. EXECUTIVE PAY

Introduction: Executive Pay As A Governance Mechanism.

In late 1994, British Gas plc. proposed changes to the remuneration packages of its senior executives. One such change resulted in a pay rise of 70% to the then CEO, Mr. Cedric Brown, thereby increasing his pay to £475,000 per year.[231] Public condemnation ensued and the media latched onto the issue of increasing executive pay under headlines such as Derailing the Gravy Train, [232] Executive Gluttony Under Attack [233] and Fat Cats in the Dock. [234] The issue soon became a political one and Mr. Brown was forced to justify his increase to a House of Commons employment committee.[235] Labour politicians argued for legislative reform,[236] whilst Conservative politicians, with their free market philosophy, were unenthusiastic.[237]

[230] R.J. Gilson and R. Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors* (1991) 43 Stan. LR. 863 at 875.
[231] Although Mr. Brown contended that the pay rise was only 28%. See J. Kampfner, *British Gas Chief Defends Large Pay Rises Before MP s* (1995) *Financial Times* January 25th at 6.
[232] (1995) *Sunday Times* January 22nd.
[233] D. Cohen (1994) *Financial Times* November 26/27th at 3.
[234] (1995) *Economist* March 4th.
[235] *Case Study: The Case of British Gas* (1996) 4 Corp. Gov.:Inter. Rev. 21 at 22-3.
[236] See *Labour Will Halt Directors Gravy Train* (1995) *Observer* April 9th.
[237] See *Portillo Steers Clear of Major s New Line on Pay* (1995) *The Times* March 2nd.

Nevertheless, the then Prime Minister, John Major, indicated that statutory changes may be required.[238]

In 1995, responding to the growing calls for reform, the Confederation of British Industry (CBI), an organisation that speaks on behalf of the business community, established a study group to examine executive pay. This group, chaired by Marks and Spencer plc s CEO Sir Richard Greenbury, reported within a few months of its formation.[239] As with Cadbury,[240] compliance with its recommendations became a Stock Exchange listing requirement.[241]

More recently, in July 1999, the DTI published a consultation document in which the Government advocated a more formal approach to determining directors remuneration.[242] Recommendations included mandatory remuneration committees for all quoted companies,[243] an increase in the disclosure of remuneration packages and the possibility of shareholder approval for the directors remuneration report.

Following on from the DTI s recommendations, on the 1st August 2002, the Directors Remuneration Report Regulations came into force.[244] These regulations inserted a new s.234B into the Companies Act 1985.[245] S.234B requires directors of quoted companies to prepare a directors remuneration report. The contents of the report are set out in a new Sch.7A which is also inserted into the Companies Act 1985. The information required in the report is extensive. Sch.7A requires that the company set out in full the composition of its remuneration committee. The bulk of the report concerns the actual remuneration itself. Directors are required to disclose in full their remuneration including all share option and long-term incentive schemes. Full

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238 See K. Brown and J. Blitz, *Dodging Through the Executive Pay Field* (1995) *Financial Times* March 2nd at 10.

239 *Directors Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury*, 1995, London: Gee Publishing Ltd.

240 In relation to executive remuneration, Cadbury made only a modest series of proposals: see *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., paras. 4.40-46. This has led to one commentator stating in the controversial area of executive pay, the report falls conspicuously short. See Leading Article: *Tightening Up Governance* (1992) *Financial Times* May 28th at 20.

241 Financial Services Authority, *The Listing Rules*, May 2000, London: FSA, para. 12.43A.

242 Department of Trade and Industry, *Directors Remuneration: A Consultative Document*, July 1999, London: DTI.

243 *Ibid.* at para. 3.15.

244 *The Directors Remuneration Report Regulations 2002*, SI 2002/1986.

disclosure of the board s service contracts is also required. Once the report is prepared, it has to be approved by the shareholders.[246]

Given these developments, one might assume that the payment of excessive remuneration would become an increasingly rare event. However, this has not been the case. Further, directors can, to an extent, conceal their total remuneration. Under the Companies Act 1985, a company is not required to specify each director s pay or provide a breakdown of a director s remuneration package, *e.g.* share options, salary and bonuses.[247] This lacuna was heavily criticised with one commentator describing the situation as Byzantine. [248] Accordingly, following Greenbury s recommendations, the Stock Exchange revised the Yellow Book (now *The Listing Rules*) to require that a listed company s remuneration committee (or the board if no committee exists) to prepare a report accompanying the accounts and an annual report setting out data on share options and long-term incentive schemes.[249] Nevertheless, there are still numerous forms of remuneration package, some of which serve to obfuscate a director's true income.

Firstly, and most obviously, directors may simply receive an inordinately high salary. Although it was Cedric Brown s £475,000 salary that ignited the issue, his salary is by no means the highest. In fact, compared to some, his is positively modest. In the same year, Peter Wood, a director for the Royal Bank of Scotland, was paid £18,473,169, an increase of 201.8% on the previous year.[250] More startling is the pay increase of Octov Botnar, a director for the Automotive Financial Group, whose pay rose to £3,809,000, an increase of 2,830%.[251]

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[245] *The Directors Remuneration Report Regulations 2002*, SI 2002/1986, reg.3.

[246] S.241A Companies Act 1985, inserted by *The Directors Remuneration Report Regulations 2002*, SI 2002/1986, reg.7.

[247] However, a company does have to supply information about share options in the notes supplementing its accounts and in the annual report: Sch.4, para.40 and sch.7, paras. 2A and 2B Companies Act 1985.

[248] D. Eggington *et al*, *Executive and Employee Share Options: Taxation, Dilution and Disclosure* (1993) 23 J. of Bus. Res. 363 at 368.

[249] Now contained in Financial Services Authority, *The Listing Rules*, May 2000, London: FSA, para. 12.43A(c), implementing *Directors Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury*, 1995, London: Gee Publishing Ltd., paras. 5.5-5.25 and Code of Best Practice, part B.

[250] Labour Research Department, *Boardroom Bonanza Continues* (1994) 83(8) Labour Research 7 at 8.

[251] *Ibid.*

One possible reason why Cedric Brown was vilified was that at the time of his pay increase, British Gas was making hundreds of employees redundant and cutting the wages of many more.[252] The relative position of senior management and their employees should be borne in mind when determining remuneration. A 1995 poll revealed that 90% of UK adults believed that inordinate rises in executive pay could reduce employee morale.[253] The Greenbury Committee recognised this when it urged remuneration committees to take into account rank-and-file wage levels when formulating executive pay.[254] This recommendation also became part of the Combined Code.[255]

However, when one compares the pay of senior executives and their workforce, there is little to indicate that this is being done. Median highest paid director pay has grown from £239,000 in 1994 to £410,000 in 1999, a rise of 72%.[256] In the same period, median average employee pay has risen from £17,332 to £20,485, a rise of 18%.[257] Thus during the period 1994-9, director pay rises outstripped employee pay rises by a ration of 4:1. In 1994, the average earnings for a male manual worker were £14,882 per year.[258] In the same year, 14 companies paid their directors at least that amount per week.[259] In 1996, the lowest basic rate at Tesco was £2.82 per hour - 145 times less than the £533.40 per hour that Tesco director, Sir Ian MacLaurin, was earning.[260]

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252 See *Nice Work If You're the Boss* (1995) *The Times* January 17th; *Big Guns Will Put Down Shareholder's Gas Revolt* (1995) *Independent on Sunday* May 28th.
253 *Salary Rises Among Leading Company Chiefs Reached 12%* (1995) *The Times* July 14th.
254 *Directors Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury*, 1995, London: Gee Publishing Ltd., para. 6.13. In 1995, Barclays Bank failed to do this and many bank workers went on strike. Their justification for greater pay increases was the substantial pay rises that the Barclays board had received. See R. Donkin, *Staff at Barclays Vote to Strike* (1995) *Financial Times* May 5th at 20.
255 Committee on Corporate Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice*, para.B.1.3 appended to Financial Services Authority, *The Listing Rules*, May 2000, London: FSA.
256 Trades Union Congress, *Top Cats: The Last Closed Shop*, August 2000, London: TUC, p.2.
257 *Ibid.*
258 Labour Research Department, *One Director Worth 127 Cleaners!* (1995) 84(7) Labour Research 11 at 12.
259 *Ibid.* These companies were SmithKline Beecham, Glaxo, Unilever, Tesco, Hanson, BET, HSBC Holdings, National Westminster Bank, Barclays Bank, Argyll, Grand Metropolitan, Tomkins, Thorn EMI and Cable & Wireless.
260 Labour Research Department, *The £4 A Minute Minimum Wage* (1996) 85(5) Labour Research 13 at 14.

The greatest difference was the pay of the highest paid director of Thorn EMI who, in 1994, earned the equivalent of 376 rank-and-file workers.[261]

Such inequalities of pay are accentuated when companies move their manufacturing base to countries where rates of pay are low. For example, in 1993, Lawrence Bossidy, CEO of US firm Allied Signal, announced on national television that his company would not shift jobs from the United States to Mexico if the North American Free Trade Agreement (NAFTA)[262] was passed. Within two years on NAFTA s passage, AlliedSignal boasted the highest number of petitions to the Department of Labor claiming job loss due to NAFTA. In 1995, Allied Signal s Mexican plant paid its employees $0.82 per hour following the peso devaluation. At that rate, Allied Signal s 3,800 Mexican employees earned a combined annual total of about $7.8 millions; less than Lawrence Bossidy s total 1995 compensation of $8.4 millions.[263]

One would suspect that this imbalance would be partially evened out by the introduction of the minimum wage. The TUC argued for a minimum wage of around £4.60 per hour. The CBI in its evidence to the Low Pay Commission, argued for a national minimum wage of between £3.10-20 per hour. The decision to set the rate at £3.60 for workers aged 18-21 was according to the CBI towards the higher end of what is acceptable to business.[264] However, if one examines the earnings of leading CBI members, it becomes clear that they value themselves much more highly than those earning the minimum wage.

Sir Clive Thompson, President of the CBI, earns £446.34 per hour as CEO of Rentokil Initial - 129.5 times the minimum wage that the CBI believes is towards the higher end of what is acceptable to business.[265] Similar trends are present among other CBI

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[261] Labour Research Department, *One Director Worth 127 Cleaners!* (1995) 84(7) Labour Research 11 at 12.

[262] NAFTA is an organization dedicated to eliminating tariffs between the US, Canada and Mexico. Many US employees correctly feared that once tariffs are removed, their jobs will be taken by Mexican employees willing to work for much less.

[263] S. Anderson and J. Cavanagh, *CEO s Win, Workers Lose: How Wall Street Rewards Job Destroyers* [Online] Available http://www.corpwatch.org/corner/glob/ips/ceo.html 29th June 2000.

[264] Quoted in Labour Research Department, *Bosses Rate Themselves Highly* (1998) 87(11) Labour Research 9 at 9.

[265] *Ibid.*

members.[266] It should be remembered that the CBI instigated the Greenbury study into executive pay and yet they themselves are amongst the highest paid. In 1995, Sir Richard Greenbury himself earned £1,156,010, excluding his non-executive directorships of Lloyds Bank and Zeneca.[267] It is therefore no surprise that this situation has been described as a case of putting Dracula in charge of a blood bank.[268] Whatever the issues involved, the major point is that inordinate executive pay rises can cause dissatisfaction amongst the rank-and-file workers. Consequently, morale and productivity will suffer.[269] Further, excessive executive earnings can complicate salary negotiations. In 1995, Barclays Bank experienced a period of severe employee dissatisfaction. During bargaining, which was marked by strike activity, Barclays employees sought to justify their wage demands by drawing attention to the substantial pay increases that the Barclays board had received.[270]

Secondly, directors may conceal their total remuneration by receiving modest salaries and then boosting their income by other means. This is most commonly done via the use of share options and/or dividend payments. Share options are popular with companies because they are seen as a means by which payment can be tied to performance. They are also popular with directors because they offer a risk-free opportunity to make a large profit.[271] Share option schemes offer the director a chance to buy a number of shares in their company, usually at a slight discount to the current market price,[272] in at least four to five years time. Once this period has passed, the director has several options. If the share price has dropped, then the

[266] *Ibid.* For example, Sir Peter Bonfield of British Telecom earns 98 times the minimum wage; Sir John Browne of British Petroleum earns 83.5 times the minimum wage and Niall Fitzgerald of Unilever earns 83.2 times the minimum wage.
[267] Labour Research Department, *High Pay: Leading By Example* (1995) 84(3) Labour Research 17 at 17.
[268] *Ibid.*
[269] L.J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay* (1992) 68 Ind. LJ. 59 at 69-70.
[270] See *Staff at Barclays Vote to Strike* (1995) *Financial Times* 5th May and *Pickets Tell How Disparity Drove Them on to the Street* (1995) *Times* 31st May.
[271] Directors can make a profit even if the share price falls. In 1995, Robert B. Palmer, CEO of American firm Digital Equipment, was granted 300,000 options at the then-market price of $48. The next year, the share price fell and his options package for 1996 was smaller and valued at $37.75 per share. Should the stock return to its depressed 1995 price, Palmer will pocket nearly $2 millions. See J. Reingold, *Executive Pay* [Online] Available http://www.businessweek.com/common_frames/bws.htm?http://www.business week.com/1997/16/b35231.html 24th August 2000.
[272] Often known as the exercise or strike price.

director simply lets the options lapse with no personal loss.[273] If, however, the share price has risen, then the director will most probably sell the shares off immediately for an instant profit. So, for example, in 1999, James Hynes, chair of telecoms group Colt, took up options on nearly a million shares and immediately sold them for a profit of £6,388,465.[274]

Proponents of performance-related pay advocate share options as a risk-free method of tying pay to performance. This however is not correct; options come at a cost. By putting more potential shares into circulation, options reduce every shareholder s slice of the profits. For example, in 1996, PepsiCo Inc. reported that its options grants reduced earnings by $68 millions or 6%.[275]

Dividends can also be used to substantially boost an director s income. One individual has stood out by consistently receiving extremely high dividends. In 1998, David Sainsbury s dividend payments amounted to £36,047,886;[276] in 1996, the figure was £38,992,623[277] and in 1995, they amounted to £37,635,924.[278] To date, the highest UK dividend payment encountered by the author went to Ronald Hobson, a director of National Parking Corp., who in 1995 received £60,413,139.[279]

Therefore, through the use of dividend payments and share options, directors can to an extent conceal from the public their true income. A startling example of this can be seen in the remuneration package of Sandford Weill, CEO of the US corporation Travellers Group, now Citicorp. In 1997, his salary amounted to just over $7

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[273] Conversely, the shareholders will incur genuine losses: see B. Walters *et al*, *Top Executive Compensation: Equity of Excess? Implications for Regaining American Competitiveness* (1995) 14 J. of Bus. Ethics 227 at 230.

[274] Labour Research Department, *Opting For A Share of the Profits* (1999) 88(6) Labour Research 15 at 16.

[275] J. Reingold, *Executive Pay* [Online] Available http://www.businessweek.com/common_frames/bws.htm?http://www.businessweek.com/1997/16/b35231.html 24th August 2000.

[276] Labour Research Department, *Big Dividend For Fat Cats* (1999) 88(1) Labour Research 25 at 26.

[277] Labour Research Department, *Double Cream Directors* (1996) 85(10) Labour Research 17 at 18.

[278] Labour Research Department, *Making A Killing On Dividends* (1995) 84(10) Labour Research 9 at 10.

[279] Labour Research Department, *Double Cream Directors* (1996) 85(10) Labour Research 17 at 18. Ronald Hobson was not the only National Parking Corp. director to gain handsomely from dividends in 1995. Sir Donald Gosling also received dividends totalling £50,823,721.

millions. However, once stock options and dividend payments were added, his total remuneration came to just over $400 millions.[280]

Thirdly, there is a growing trend amongst large companies to issue sizeable payments to departing directors. These payments, or golden handshakes as they are known, are steadily increasing in both size and number. To date, the largest golden handshake discovered by the author was to Jim Fifield, the departing director of Thorn EMI, who, in 1998, received £12,420,000.[281] A more worrying trend is the payment of golden handshakes to directors departing due to poor performance. In 1993, due to a series of poor financial reports British Aerospace sacked 21,000 employees. The CEO, John Cahill, thought this a matter of considerable regret [282] and promptly resigned. However, despite his failure, he still received a golden handshake of £3.1 millions.[283] Similarly, Phillip Green received £1,132,000 when he left department store group Amber Day in the same year that the company announced a loss of £7 millions.[284] In America, departing directors have been able to negotiate even more incredible retirement plans. Recently, Coca-Cola s CEO Douglas Ivester announced his retirement. During his two-year tenure as CEO, the company produced a negative return to shareholders of 7.3%, and yet he walked away with a golden handshake of $120 millions. He was also able to negotiate a separation agreement that included annual payments of $1.5 million, additional monthly payments of $66,300, medical benefits for himself and his wife, office space and secretarial services, maintenance of his home security systems and club dues for his existing club memberships. He also received title to his company car, cell phones and computers.[285]

Finally, we are starting to see the appearance of golden hellos. These are payments given to directors merely for agreeing to join a company and, as such, are not in any

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280 See Forbes Magazine, *The Top Paid CEO s* [Online] Available http://www.forbes.com/forbes/98/0518/6110224a.htm. 14th March 2000.

281 Labour Research Department, *Goodbye and Thanks A Million* (1998) 87(10) Labour Research 11 at 12.

282 Quoted in Labour Research Department, *More Than A Fond Farewell?* (1994) 83(9) Labour Research 23 at 23.

283 *Ibid.*

284 *Ibid.* Similarly, Mr. Bob Horton, ousted as CEO of British Petroleum plc. in 1992 after profits collapsed, was awarded £1.5 million upon his departure.

285 Executive Pay Watch, *Case Studies in Global CEO Pay* [Online] Available http://www.aflcio.org/paywatch/2cl_m1.htm 18th April 2000, p.3.

way tied to performance. The top golden hello discovered by the author to date went to Ann Iverson when she agreed to become CEO of textile group Laura Ashley. Previously president and CEO of US company Kay Bee Toy Stores, she received a £350,000 signing on bonus.[286] Likewise, her fellow director, James Walsh, received a £100,000 welcome.[287]

It is now universally acknowledged that board compensation, and the mechanisms that regulate it, are one on the most important incentive mechanisms that shape and direct director behaviour.[288] Accordingly, an effective mechanism for regulating board remuneration will benefit society by guiding directorial efforts towards legitimate economic and societal goals. These mechanisms will now be examined.

Remuneration Committees.

It is a fundamental rule of equity that directors and fiduciary agents shall not make any profit from their office and therefore have no claim as of right to be remunerated for their services.[289] Directors are entitled only to receive remuneration which has been authorised by the shareholders[290] or a body authorised to remunerate by the articles of association.[291] In the UK, this power is usually vested in the company s board.[292] These details are then usually set out in service contracts that the executives will enter into with the company. In other words, remuneration levels depend largely on the executive s self-discipline.[293] Concerns that directors would award themselves inflated remuneration packages led many to conclude that the board should delegate

[286] Labour Research Department, *Basking in Golden Retirement* (1996) 85(8) Labour Research 9 at 10. Similarly, Stephen Brandon received £100,000 when he joined British Gas, as did Roy Gardner; George Charters received £160,000 when he joined Safeway and Kevin McCarten received £62,000 when he joined marketing group J. Sainsbury.
[287] *Ibid.*
[288] See *e.g.* J. Cordeiro, R. Veliyath and E.J. Erasmus, *An Empirical Investigation of the Determinants of Outside Director Compensation* (2000) 8 Corporate Governance: An International Review 268; L.R. Gomez-Mejia and R.M. Wiseman, *Reframing Executive Compensation: An Assessment and Outlook* (1997) 23 Journal of Management 291.
[289] *Hutton v West Cork Railway Co.* (1883) 23 Ch.D. 654.
[290] Art.82 Table A in Companies (Tables A to F) Regulations 1985, SI 1985/805.
[291] *Guinness plc. v Saunders* [1990] 2 AC 663; *Runciman v Walter Runciman plc.* [1992] BCLC 1084.
[292] Arts.72 and 84 Table A in Companies (Tables A to F) Regulations 1985, SI 1985/805.
[293] W. Forbes and R. Watson, *Managerial Remuneration and Corporate Governance: A Review of the Issues, Evidence and Cadbury Committee Proposals* (1993) 23 Accounting and Business Res. 331 at 331.

the function of determining remuneration to a remuneration committee.[294] Subsequent proposals went further and advocated that the remuneration committee should consist entirely of non-executive directors.[295] Currently, The Listing Rules do not require companies to set up remuneration committees, although the Combined Code appended to The Listing Rules does.[296] However, the DTI recommends that all quoted companies be formally required to set up a remuneration committee consisting entirely of independent NEDs.[297]

These recommendations have been followed almost unanimously. In 1990, 45.64% of companies had set up a remuneration committee.[298] By 1995, this figure was 97.99%.[299] However, in order for these committees to be successful [e]xecutive directors should play no part in decisions on their own remuneration. [300] However, purging executive influence from remuneration committees has not been so easy.

Regarding the removal of executive influence, the figures are encouraging. A 1995 survey revealed that 51.22% of remuneration committees had no executive members.[301] By 1999, this figure was 97%.[302] It used to be common for the executive CEO or chairman to also chair the remuneration committee.[303] By 1999,

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[294] *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para. 4.42.

[295] *Directors Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury*, 1995, London: Gee Publishing Ltd., para. 4.8. R. Bostock, *Company Responds To Cadbury* (1996) 4 Corp. Gov.: Inter. Rev. 72 at 74 contends that executive free remuneration committees were emerging before Greenbury s recommendations.

[296] Committee on Corporate Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice*, para.B.2.1 appended to Financial Services Authority, *The Listing Rules*, May 2000, London: FSA.

[297] DTI, *Directors Remuneration: A Consultative Document*, July 1999, London: DTI, para. 3.15.

[298] M.J. Conyon, *Institutional Arrangements For Setting Directors Compensation in UK Companies* in K. Keasey, S. Thompson & M. Wright (eds.), *Corporate Governance: Economic, Management and Financial Issues*, 1997, New York: OUP, p.111.

[299] *Ibid.* See also M.J. Conyon, *Corporate Governance Changes in UK Companies Between 1988 and 1993* (1994) 2 Corp. Gov.: Inter. Rev. 87 at 93-5 who states that 94% of companies had set up a remuneration committee.

[300] *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para. 4.42.

[301] M.J. Conyon, *Institutional Arrangements For Setting Directors Compensation in UK Companies* in K. Keasey, S. Thompson & M. Wright (eds.), *Corporate Governance: Economic, Management and Financial Issues*, 1997, New York: OUP, p.112.

[302] PriceWaterhouseCoopers, *Monitoring of Corporate Governance Aspects of Directors Remuneration* [Online] Available http://www.dti.gov.uk/cld/pwcrep.pdf, 28th March 2000, p. 7. This document can also be found in Department of Trade and Industry, *Directors Remuneration: A Consultative Document*, July 1999, London: HMSO, annex B.

[303] M.J. Conyon, *Corporate Governance Changes in UK Companies Between 1988 and 1993* (1994) 2 Corp. Gov.: Inter. Rev. 87 at 95-7.

only 27% of chairman chaired the remuneration committee,[304] although this figure could be less. However, the figures do not tell the whole story.

For example, it is standard practice for the actual executive pay details to be worked out by an outside firm of compensation consultants working to guidelines set by the remuneration committee but hired by the executives.[305] If a compensation consultant becomes well-known for recommending frugal remuneration packages, he will become unpopular with executive management and will lose his client base. Compensation consultants themselves admit this. Peter Brown of the Top Pay Research Group has stated [y]ou are not going to tell your clients what they don t want to know. What is the point of telling them to cut pay if that will not work. We give practical, not other-worldly advice. [306]

Even where executive influence is not the problem, there still exists considerable dissatisfaction with the remuneration committee s effectiveness. A 1994 survey actually discovered that companies with a remuneration committee paid their executives more than companies without and did little to align pay and performance.[307] This has led two commentators to conclude that these committees seem to do little more than legitimise generous pay awards. [308] Put even more starkly, the concern is that remuneration committees may provide a veneer of independence which cloaks a system of mutual back-scratching amongst directors. [309] The reasons for this can be traced to the inadequacies of the monitoring function of NEDs and the aforementioned problems regarding their selection.[310]

As noted, the chairman, working with a nomination committee, will select the NEDs. These people will usually have been chosen on the basis that they fit in with the

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[304] PriceWaterhouseCoopers, *Monitoring of Corporate Governance Aspects of Directors Remuneration* [Online] Available http://www.dti.gov.uk/cld/pwcrep.pdf, 28th March 2000 p.7.
[305] Greenbury itself acknowledged this: see *Directors Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury*, 1995, London: Gee Publishing Ltd., para. 4.17.
[306] Quoted in N. Garnett, *More Than A Fond Farewell: An Eye on the Big Earners* (1993) *Financial Times* April 24/25th at VIII.
[307] *Risk of Losses in New Issues* (1994) *Independent on Sunday* February 27th.
[308] B. Main and J. Johnston, *Deciding on Top Pay by Committee* [1992] July, *Personnel Management* 32 at 35.
[309] E. Ferran, *Company Law and Corporate Finance*, 1999, Oxford: OUP, p.222.

company in the sense that they identify with its goals and are compatible with the management team. [311] Such individuals if placed on a remuneration committee, may well be reluctant to speak out against generous executive pay.[312]

These NEDs, as we have seen, may well be executives in other companies. If executives in one company were present as non-executives on the remuneration committee of another, this would be worrying indeed. This would suggest a you scratch my back and I ll scratch yours situation. [313] Indeed, there is some evidence of an old boys network operating in this country. In 1999, amongst the top 98 companies, 30 directors sat on more than one remuneration committee.[314] Topping the list with four remuneration committee appointments apiece were Sir Michael Angus[315] and Sir John Banham.[316] Further, both men sit on two remuneration committees in an executive capacity. This being said it is very rare that executives in a pair of listed companies will advise directly on each others pay.[317] Furthermore, cross-directorships have to be disclosed to the shareholders.[318] Nevertheless, such individuals are setting, if only indirectly, the going rate for executive management. This creates an opportunity for them to raise the benchmark of their own pay. They may therefore be sympathetic to pay increases.[319]

Executive Pay: The Role of the Law.

Despite the self-regulatory stance in this area, there do exist legal constraints on the board s power to determine remuneration. S.319 Companies Act 1985 prohibits

[310] M.J. Conyon, *Institutional Arrangements for Setting Directors Compensation in UK Companies* in K. Keasey, S. Thompson & M. Wright (eds.), *Corporate Governance: Economic, Management and Financial Issues*, 1997, New York: OUP, p.119.
[311] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, pp.668-9.
[312] G.S. Crystal, *In Search of Excess: The Overcompensation of American Executives*, 1991, New York: W.W. Norton, pp.226-7.
[313] A.R. Brownstein and M.J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?* (1992) May-June, Harv. Bus. Rev. 28 at 38.
[314] Labour Research Department, *Fat Cats & the Old Boys Network* (1999) 99(7) Labour Research 19 at 19.
[315] Sir Michael Angus sits on the remuneration committees of NatWest, Britsh Airways, Boots and Whitbread.
[316] Sir John Banham sits on the remuneration committees of Kingfisher, AMVESCAP, National Power and Tarmac.
[317] *Pay and the Old Boy Network* (1991) *Independent on Sunday* November 24th.
[318] *Directors Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury*, 1995, London: Gee Publishing Ltd., para. 4.8 and *Code of Best Practice*, para. A4.
[319] See *Punters or Proprietors?* (1990) *The Economist* May 5th at 10.

companies from entering into service contracts with directors for a term of more than five years without shareholder consent.[320] This provision was first introduced in the 1980 Act to stop directors entering into long-term contracts and thereby entrenching themselves by making their removal prohibitively expensive. S.312 Companies Act 1985 provides that shareholders must give their approval before the company provides *ex gratia* payments to directors leaving office.[321]

Most notably, whatever the nature of the board s power over directors remuneration, they are subject to an overriding duty to exercise it *bona fide* in the interests of the company [322] One would assume that if the director was receiving exorbitant remuneration, then the shareholders could take action on the grounds that it was clearly not in the interests of the company.[323] However, the effectiveness of this duty is limited by its focus on proper purpose as opposed to the merits of a particular decision, indicating once more the court s reluctance to interfere in matters of business judgment.[324] The court in *Runciman v Walter Runciman plc*.[325] confirmed that the apparent generosity of an award of remuneration will not constitute a breach of duty despite the obvious disadvantage to the company. The court will only act to determine whether payments are actual remuneration or whether they are fortuitous distributions to a shareholder out of capital dressed up as remuneration. [326] In a series of cases, stemming from the same facts, arguments based on director s duties were unsuccessful in curtailing excessive remuneration.[327] Conversely, in America, cases concerning excessive remuneration are reasonably common.[328]

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[320] *The Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, London: Gee Publishing Ltd., para. 4.41 recommended that service contracts should not exceed three years. *The Report of the Committee on Corporate Governance*, 1998, London: Gee and Co., para. 4.9 went further and advocated a reduction to one year.

[321] Ss.313 and 314 Companies Act 1985 impose analogous restrictions regarding payments that take place when a company is undergoing a change in control.

[322] *Re Smith & Fawcett Ltd.* [1942] Ch. 304 at 306, *per* Lord Greene MR.

[323] *Directors Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury*, 1995, London: Gee Publishing Ltd., p.35, stated that directors who receive pay that is over the odds are in breach of this duty.

[324] See *e.g.*, *Howard Smith v Ampol Petroleum* [1974] AC 821 at 832, *per* Lord Wilberforce: There is no appeal on merits from management decisions to courts of law; nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.

[325] [1992] BCLC 1084.

[326] *Re Halt Garage (1964) Ltd.* [1982] 3 All ER. 1016 at 1042, *per* Oliver J.

[327] *Smith v Croft* [1986] 1 WLR 580; *Smith v Croft (No.2)* [1988] 1 Ch. 114 and *Smith v Croft (No.3)* [1987] BCLC 355.

[328] For a discussion of the American position, see D. Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?* (1983) 8 J. of Corp. L. 252-7, 263-6.

However, in Zemco v Jerrom-Pugh,[329] the Court of Appeal did find circumstances in which a breach of duty could be established. Here, the board had paid one of its two directors a year s salary in advance shortly before he was dismissed by the company s new controllers. The Court held:

> The only purpose of the payment was to secure Mr. Jerrom-Pugh against the possibility that when the money actually fell due either the new management of the company might be reluctant to pay or, alternatively, the company might be in insolvent liquidation. Accordingly, it is clear beyond doubt that the payment was in breach of fiduciary duty on the part of the directors and that accordingly Mr. Jerrom-Pugh held the money as constructive trustee for the company. [330]

Ascertaining the directors proper purpose is notoriously difficult. In Zemco, there was no clear evidence of a proper purpose; the minutes of a board meeting could have provided this. It has been contended that where such evidence is lacking, the court should adopt a more stringent approach than exhibited in Runciman and place the burden of justification on the director.[331] With the enhanced risk of detecting an improper purpose, procedural formality would be reinforced thereby safeguarding the company and its shareholders.

The Shareholders as Monitors of Executive Pay.

The legal model of the company dictates that the shareholders are residual claimants; all the directors are entitled to is the market rate for the services they provide. Directors who pay themselves too much are in effect increasing agency costs, which directly affects the shareholders. If the board of directors or the remuneration committee has shown itself ineffective in regulating the directors remuneration, then one would imagine that the shareholders would be keen to intervene. If they do not, an opportunity to reduce agency costs will be lost.[332] Profits destined for shareholders

[329] [1993] BCC 275.
[330] *Ibid.* at p.281, *per* Hoffmann LJ. He was therefore not allowed to set-off this payment against his claim for wrongful dismissal.
[331] A. Griffiths, *Directors Remuneration: Constraining the Power of the Board* [1995] LMCLQ 372 at 383.
[332] P. Gregg *et al*, *The Disappearing Relationship Between Directors Pay and Corporate Performance* (1993) 31 Brit. J. of Ind. Res. 1 at 8.

will be dissipated,[333] reduced employee morale will cause a loss in productivity and the share price might be adversely affected.[334]

However, although shareholders have occasionally intervened in executive pay issues, there are several reasons why, for the most part, they do not intervene.

Firstly, there are procedural barriers. An individual shareholder who tries to challenge an executive s pay by means of procedural irregularity or breach of duty will soon discover that doing so is extremely difficult. Such infringements must be litigated through the medium of the company, and, therefore, the rule in Foss v Harbottle[335] will usually preclude a member from suing on the company s behalf. However, there are exceptions to this rule. One possibility concerns the *ultra vires* doctrine, namely that if there has not been a genuine exercise of a company s remuneration power, the court can set aside the arrangement as an unauthorised gift.[336] Another possibility concerns the unfair prejudice remedy contained in s.459 Companies Act 1985. S.459 is not subject to the procedural constraints of Foss v Harbottle and, further, the courts have indicated that excessive remuneration can be unfairly prejudicial.[337] However, neither option is ideal. Certain members of the judiciary have indicated that they are reluctant to use the *ultra vires* doctrine to resolve disputes concerning executive pay.[338] Further, s.459 as regards executive pay, is much more likely to work if the company in question is closely-held as opposed to the type of company that we are focusing on, the public company.[339]

Secondly, for a shareholder who owns a small stake in a public company s equity, the costs of mounting a challenge will often outweigh the benefits.[340] According to a

333 G.S. Crystal, *In Search of Excess: The Overcompensation of American Executives*, 1991, New York: W.W. Norton, pp.172-3.
334 L.J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay* (1992) 68 Ind. LJ. 59 at 67, 69-70.
335 (1843) 2 Hare 461.
336 *Re Halt Garage* [1982] 3 All ER. 1016. Note, however that this case concerned a director who had performed no services during the relevant period. It may therefore legitimately be confined to similar facts.
337 See *Re Cumana Ltd.* [1986] BCLC 430; *Sandford v Sanford Courier Services Pty. Ltd.* (1986) 10 ACLR 549 (concerning the Australian equivalent, s.260 Australian Corporations Law).
338 See for example, *Smith v Croft (No.2)* [1988] 1 Ch. 114 at 159-64, *per* Knox J.
339 B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p. 666.
340 *Cf.* the position of a shareholder in a closely-held company:

1990 study, the top managerial salaries of 800 leading US corporations amounted to less than 1% of all corporate profits.[341] The UK position is likely to be similar, especially as UK directors are paid less than their American counterparts.[342] As excessive remuneration is unlikely to have a significant effect on profits, the return that shareholders accrue from corrective action will be minuscule.[343] Indeed, it may be the case that such action will cost the company more than it saves. When Cedric Brown announced his pay increase, many private shareholders wished to attend the 1995 AGM in order to voice their dissatisfaction. The coasts of mounting such an AGM were estimated at £530,000, almost £60,000 more than his full salary.[344]

Thirdly, individual members will often find it difficult to obtain the information necessary to mount a challenge. If the board needs to defend a proposed remuneration package, it will have access to the information compiled by the remuneration committee. Conversely, the challengers will be in a much more inferior position to put forward their case.[345] Although Greenbury recommended that such information be available to the members,[346] neither the Stock Exchange, nor its successor the FSA, has made this requirement part of its listing rules.

Therefore, the question that now occupies us is how can we enhance the role of the shareholders in relation to executive pay issues. One possibility is to increase the scope of judicial intervention. In Australia, the courts have considerable powers regarding the regulation of executive pay. There, a public company is prohibited from providing remuneration to managers unless the shareholders have approved the

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> Levels of management compensation are related to the degree to which a firm is closely held because major shareholders have a meaningful economic incentive to engage in monitoring activities that reduce the residual loss portion of agency costs.

See E.A. Dyl, *Corporate Control and Management Compensation: Evidence on the Agency Problem* (1988) 9 Managerial and Decision Economics 21 at 24.

341 L.J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay* (1992) 68 Ind. LJ. 59 at 67.

342 Returning once more to British Gas, Cedric Brown s controversial salary of £475,000 was 3,000 times less than the company s profits for that year: see Lex Column, *Gas Chief Defends Pay Rise* (1995) *Financial Times* January 25th at 6.

343 *Shadow SEC Roundtable on the New Disclosures of Executive Pay* (1993) 5 J. of App. Corp. Fin. 62 at 73 (Professor Michael Jensen on the US situation commented [i]f you took all the CEO s of our 1,000 largest companies and got them to work for nothing forever, the effect on aggregate shareholder wealth would be almost imperceptible.)

344 *Shareholders Wrath Forces AGM Switch* (1995) *Financial Times* May 18th.

345 R.C. Clark, *Corporate Law*, 1986, Boston: Little, Brown, p.201.

346 *Directors Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury*, 1995, London: Gee Publishing Ltd., paras. 5.1-5.7 and *Code of Best Practice*, para. B2.

arrangement or its is exempt because it is reasonable. [347] However, it is unlikely that judicial intervention will increase here. As noted, the judiciary is reluctant to use the *ultra vires* doctrine or s.459 as a means of regulating executive pay. Further, English judges are often unwilling to scrutinise corporate decisions honestly arrived at. The US experience shows that a conservative judiciary can emasculate a statute designed to regulate executive pay. There, the court can grant relief if payments to directors constitutes waste. However, to date, the court has not found any pay so excessive as to constitute waste.[348]

Apart from those measures discussed earlier, shareholders did not, until recently, have a vote on matters of remuneration. Accordingly, the only option left to shareholders was to vote the directors out of office under s.303 Companies Act 1985.[349] A less drastic method of intervention was required. Now, as we have noted, the shareholders are required to approve the directors remuneration report under the new s.234A Companies Act 1985.[350]

Strengthening the Link Between Pay and Performance.

One should note that the function of the remuneration committee or the role of law in determining executive pay is not to limit it, but rather to more effectively tie pay to performance. It is clearly unacceptable for a company on the brink of insolvency to pay its directors an exorbitant salary. However, if a company is performing well, then it is perfectly legitimate, if not commercially beneficial,[351] to pay the board handsomely. Accordingly, many commentators argue that a significant proportion of the director s remuneration should be linked to performance.[352] However, a

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[347] S.243K Corporations Act 1989, Act No.109 of 1989, added by s.27 Corporate Law Reform Act 1992, Act No.210 of 1992. For more on the Australian position, see A. Defina *et al*, *What is Reasonable Remuneration for Corporate Officers? An Empirical Investigation Into the Relationship Between Pay and Performance in the Largest Australian Companies* (1994) 12 C&SLJ. 341.
[348] C.M. Elson, *Executive Overcompensation-A Board Based Solution* (1993) 34 Boston Coll. L. Rev. 937 at 959-66.
[349] There are those who have urged that shareholders should use this threat more often: see *Reward for Failure* (1996) *Independent on Sunday* March 10th.
[350] Inserted by *The Directors Remuneration Report Regulations 2002*, SI 2002/1986, reg.7.
[351] For example, setting a high pay make entice talented individuals to join the company: see D. Bok, *The Cost of Talent: How Executives and Professionals are Paid and How it Affects America*, 1993, New York: Macmillan, pp.115-6.
[352] Committee on Corporate Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice*, 1998, Principle B.1 appended to Financial Services Authority, *The Listing Rules*, May 2000, London: FSA.

common theme amongst not just UK companies, but also American[353] and Australian[354] corporations is that pay is not adequately tied to performance. It is a popular thesis that executives are handsomely rewarded when the company s share price goes up but suffer few negative consequences when equity values decline.

The most obvious method of linking pay to performance is based on the premise that pay should fluctuate along with shareholder return. The theory which underpins this approach is that an executive needs to be motivated to think like a shareholder. [355] From a shareholder s perspective, the benefits of this approach are obvious. As the executive occupies a similar beneficiary position as a shareholder, he will place a high priority on the shareholder s investment.[356] In the UK, it is generally perceived that executive pay has little correlation with shareholder return.[357] In October 1999, a PIRC report found that of almost 100 new share option and similar schemes for directors of listed companies, two thirds will pay out if the company s earnings per share figure rises by 3% above the rate of inflation — a target broadly in line with general growth forecasts, and therefore representing only average corporate performance.[358] Similarly, PriceWaterhouseCoopers found that seven out of ten directors could be receiving performance-related share option payouts, despite their businesses turning in average or below average results. [359] The same is true of American companies. A 1991 survey discovered that when the share price rose 10%, the CEO s salary increased 13.4%. However, when the share price decreased 10%, then the CEO s salary still rose 4.1%. Even a 55% decrease in share price still

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[353] See H. Stretton, *Directors Pay* in M. Dugan (ed.), *Furious Agreement*, 1991, p. 14: Waving the banner of pay-for-performance, bosses have acted like Barbary pirates, plundering the cash flows of America s biggest firms with little regard for shareholders or fellow employees. For example, Stephen M. Case, CEO of America Online Inc. earned $33.5 millions between 1993 and 1996, yet his company s return on equity was negative 413%. See L. Bongiorno, *Which Bosses Earned Their Pay and Which Didn t?* [Online] Available http://www.businessweek. com/1997/16/b352311.html 24th August 2000.

[354] *E.g.* during 1990-91, shareholders funds in Australian company Adelaide Steamship fell from A$1.7 billion to A$67.4 millions. Yet the managing director received a 25% pay rise to A$1.51 million.

[355] B.M. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.678.

[356] M.C. Jensen and K.J. Murphy, *Performance Pay and Top-Management Incentives* (1990) 98 J. of Pol. Econ. 225 at 225-6, 242-3.

[357] P. Gregg *et al*, *The Disappearing Relationship Between Directors Pay and Corporate Performance* (1993) 31 Brit. J. of Ind. Res. 1 at 8; *Random Numbers* (1995) *Economist* June 3rd. *Cf.* W. Lewis, *Directors Pay Moving Closer to Performance* (1996) *Financial Times* May 7th at 7.

[358] Quoted in Trades Union Congress, *Top Cats: The Last Closed Shop*, August 2000, London: TUC, p.4.

[359] PriceWaterhouseCoopers, *Sharing in the Boardroom 2000: Incentive Arrangements in Large UK Companies*, May 2000, London: PriceWaterhouseCoopers.

resulted in only the CEO earning the same as the previous year.[360] An earlier study came to the following worrying conclusion:

> The [data implies] that on average CEO wealth increases by $918,000 in years in which shareholders earn a zero return Thus the average pay-related wealth increase for a CEO whose shareholders gain $400 million is $1.04 million, compared to an average annual wealth increase of $800,000 for a CEO whose shareholders lose $400 million. [361]

This does not mean, however, that remuneration is unaffected by the share price. It is common for directors, via a bonus scheme, to be rewarded if certain performance criteria are met. For example, an executive might receive an additional sum, perhaps in the form of equity,[362] if the company s shares trade above a certain level.[363]

However, we should be wary of tying more closely executive pay to shareholder return. The thesis that management remuneration should be tied to shareholder return assumes that directors act solely in their own financial interests.[364] Such an unremarkably flattering [365] assumption is not wholly true. Directors may also seek less tangible rewards such as a high level of prestige and social or political power.[366] However, these goals will complement, not replace, an executive s desire for substantial remuneration packages. Empirical evidence exists which indicates that the potential to earn large sums is a major factor for aspiring executives.[367]

Given this, an executive may be wary of joining a company that allows pay to fluctuate according to the share price.[368] Further, existing directors may leave. As

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360 G.S. Crystal, *In Search of Excess: The Overcompensation of American Executives*, 1991, New York: W.W. Norton, p.147.

361 M.C. Jensen and K.J. *Murphy, Performance Pay and Top-Management Incentives* (1990) 98 J. of Pol. Econ. 225 at 232. The same survey discovered that for every $1,000 increase in company value, the CEO s salary increased just 3.3 cents.

362 Although the shares will usually be restricted, in the sense that a director will not be able to trade them for a number of years.

363 Such an arrangement is often called a phantom share scheme: see S. Pickering, *Employee Share Schemes: More Complex Structures* (1993) July, PLC 43 at 51.

364 V.L. Blackburn, *The Effectiveness of Corporate Control* (1994) 2 Corporate Governance 196 at 197.

365 D. Bok, *The Cost of Talent: How Executives and Professionals are Paid and How it Affects America*, 1993, New York: Macmillan, p.109.

366 See M.C. Jensen and K.J. Murphy, *Performance Pay and Top-Management Incentives* (1990) 98 J. of Pol. Econ. 225 at 252.

367 See A. Francis, *Company Objectives, Managerial Motivations and the Behaviour of Large Firms: An Empirical Test of the Theory of Managerial Capitalism* (1980) 4 Camb. J. of Econ. 349 at 352-3 who states that of a total of 17 managerial goals, the potential of earning a high income ranked 6th.

368 S. Finkelstein and D.C. Hambrick, *Chief Executive Compensation: A Synthesis and Reconciliation* (1988) 9 Strategic Mgmt. J. 543 at 551-2.

one US businessman and multiple remuneration committee member stated You can t just keep your guys if you allow a lot of swing in pay. People can t live that way, and boards don t let it happen. [369] Empirical evidence exists which states that manager controlled firms have much more stable remuneration packages than shareholder controlled firms:

> Management controlled firms clearly design compensation systems to avoid the vagaries of fluctuating performance and to take advantage of a more stable factor, size . The managers in owner controlled firms were in riskier positions- they were primarily awarded for performance, a more variable and risky factor, in all components of compensation. [370]

Accordingly, companies that doggedly link pay with performance may soon find that they have to change their philosophy.[371] Even if a director does stay with the company, a fluctuating remuneration package that is linked to performance may encourage him to become more risk-averse.[372] Further, an executive with a pay regime dependant upon shareholder return will be concerned by his lack of diversification. As has already been noted regarding the shareholders portfolio, diversification is a prudent investment strategy since the result is the spreading of risk. However, most executives are poorly diversified. A typical executive will have significant human capital tied up in his firm to the extent hat he is likely to be over invested. Unless such executives are not concerned with placing all their eggs in one basket, they will probably not want to have their income tied directly to the fortunes of the firm. Accordingly, they will not be keen on their remuneration taking the form of equity or on having their pay determined in accordance with the share price.[373]

Given these problems, it is no surprise that only a small part of a director s remuneration will be linked to performance. As one US survey concluded:

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[369] *The People Who Set the CEO s Pay* (1990) *Fortune* March 12th 58 at 58.
[370] L.R. Gomez-Mejia, H. Tosi and T. Hinkin, *Managerial Control, Performance and Executive Compensation* (1987) 30 Academy of Mgmt. J. 51 at 65-6.
[371] Salomon Brothers, a US investment bank, discovered this to their detriment. In 1995, the firm tied the pay of senior bankers and directors to the firm s performance. The philosophy behind the scheme was to make the firm s directors behave like owners. Instead, numerous key staff resigned. Ultimately, Salomon had to abandon almost the entire scheme. See P. Harverson, *Salomon Forces Directors to Share Pain as Well as Gains* (1994) *Financial Times* November 7th and M. Urry, *Salomon Shelves Plan to Cut Salaries of Top Earners* (1995) *Financial Times* June 13th at 22.
[372] C.W. Smith and R.L. Watts, *Incentive and Tax Effects of Executive Compensation Plans* (1982) 7 Australian Journal of Management 139 at 145-7.
[373] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.686.

> most studies share something in common: the total amount of explained variance in executive pay attributed to firm performance is minimal, seldom exceeding 15 per cent, and often well under 10 per cent. [374]

Further, under a scheme of performance related pay, an outstanding economic year can be used to justify exorbitant pay increases. For example, in 1996, America experienced a year of outstanding economic growth. The Standard & Poor s 500-stock index rose an unprecedented 23% and corporate profits rose an impressive 11%.[375] Surely in such a year no one could begrudge US CEO s a healthy pay rise.

Unfortunately, CEO s took a great deal more than a healthy pay rise. In 1996, CEO gains far outstripped America s booming economic performance. A CEO s average salary rose 39% to just over $2.3 millions. Add to that stock options and incentive schemes and total CEO compensation rose an astounding 54% to $5,781,300.[376] Further, American factory employees gained a raise of just 3% with white-collar workers edging ahead with 3.2%. Under the banner of performance-related pay, such inordinate pay rises can be justified. In the same year, Lawrence M. Coss, CEO of the little-known company Green Tree Financial Corp., earned $102.4 millions - a rise of 56% over his 1995 income of $65.6 millions. When questioned about this huge increase, Coss was not apologetic stating [i]ndeed it is a huge number but I d rather talk about the success of the company. [377] This seems to be enough to appease the shareholders. Thomas W. Smith, a partner at Prescott Investors Ltd., which holds 2.7 million shares in Green Tree, stated [i]n no way would I consider him overpaid. Maybe he was not aware that Coss pay increase cut Green Tree s earnings 16% to $308.7 millions.

Those companies who do seem to be effectively tying pay to performance are doing so not because of any regulatory pressures, but because of a willingness by their CEO to keep pay low. Between 1995 and 1996, sales of Microsoft s products jumped from $5.9 billions to $8.7 billions and Microsoft s web browser, Internet Explorer, had

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[374] H.L. Tosi and L.R. Gomez-Mejia, *The Decoupling of CEO Pay and Performance: An Agency Theory Perspective* (1989) 34 Administrative Science Quarterly 169 at 185.

[375] J. Reingold, *Executive Pay* [Online] Available http://www.businessweek.com/common_frames/bws.htm?http://www.businessweek.com/1997/16/b35231.html 24th August 2000.

[376] *Ibid.*

[377] *Ibid.* This would not be hard to do. Between 1991 and 1996, Green Tree s shares had annual returns of 53%.

acquired more than 20% of the market share.[378] Shareholder returns jumped over 310%. Yet between 1994 and 1997, William H. Gates total pay amounted to just $1.4 millions.[379] Similarly, between 1991 and 1996, James E. Preston, CEO of Avon Products Inc., froze his annual pay at just $610,000 and achieved a return on equity of 141%.[380]

Conclusion.

One commentator has described executive remuneration as a central governance issue. [381] However, as we have seen, like many of the corporate governance mechanisms that we have examined, it is in many ways flawed. This is because, as Cheffins has correctly stated [e]xecutive pay is a topic where it is much easier to find problems that solutions. [382] Indeed this Part has not set out to offer any solutions to the problem of executive pay. Rather, it is intended to reawaken an important debate that seems to have lost its way. The recommendations of the Greenbury Committee, whilst they are being followed, were not particularly radical or effective. The reliance on NEDs contains an inherent flaw, namely the inadequacies of the office of non-executive director. Similarly, another common theme is that pay should be more closely tied to performance. However, as we have seen, this may not be desirable. The philosophy of many performance-related schemes is to make directors behave more like shareholders, but is this really desirable? Such a scheme could result in a potential bane of company law, namely short-termism. It may be time to admit that despite the success of self-regulation in corporate governance matters, executive pay is one area where self-regulation has not proved effective. Directors simply have too much to lose by imposing upon themselves measures that serve to limit their pay. Accordingly, if they will not impose accountability upon themselves regarding

[378] L. Bongiorno, *Which Bosses Earned Their Pay and Which Didn t?* [Online] Available http://www.businessweek.com/common_frames/bws.htm?http://www.businessweek.com/1997/16/b352311.html 24th August 2000.

[379] *Ibid.* Of course, one possible reason for this is that his 15% stake in Microsoft is worth an estimated $50 billions.

[380] *Ibid.* With $22 millions worth of share options still unexercised, Preston advocates performance-related pay stating I will do well or not depending on how the stock does.

[381] M.J. Conyon, *Institutional Arrangements for Setting Directors Compensation in UK Companies* in K. Keasey, S. Thompson & M. Wright (eds.), *Corporate Governance: Economic, Management and Financial Issues*, 1997, New York: OUP, p.119.
The Disclosure of UK Boardroom Pay: the March 2001 DTI Proposals (2001) 9(4) Corporate Governance: An International Review 276 at 276.

[382] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.706.

executive remuneration, the courts or Parliament may have to. Parliament has shown itself willing to impose statutory regulation in this area following the enactment of The Directors Remuneration Report Regulations 2002.[383]

The legal model dictates that companies should be run in the interests of shareholders. Under this model, corporate governance mechanisms would have shareholder protection as their primary function. We have noted that the aforementioned mechanisms, such as the AGM, all operate to benefit the shareholders by protecting them or giving them residual managerial powers. The rules relating to executive remuneration epitomise this philosophy. The current preoccupation with linking pay to performance theoretically ensures that the directors benefit if the share price rises. Accordingly, the rules relating to executive remuneration provide directors with an incentive to maximise shareholder value, or to put it more bluntly, to run the company in the interests of the shareholders. Accordingly, they fully embody the philosophy behind the legal model of the company.

However, the current mechanisms relating to executive remuneration do little to allay the fears of non-shareholders who may also be concerned by executive pay levels. These individuals will not be particularly interested in linking pay to performance. Instead their concern will simply be the level of managerial remuneration; from their point of view company executives are simply paid too much. Reforming remuneration committees and increasing shareholder power is unlikely to alleviate these concerns.

V. THE MARKET FOR CORPORATE CONTROL

Introduction.

We have seen that traditionally, internal mechanisms are perceived as providing only weak sources of accountability. Accordingly, the Anglo-American system of corporate governance relies on an external form of governance, namely the hostile takeover bid or, as it is known in governance terms, the market for corporate control. Indeed, as Macey and Miller have stated the market for corporate control lies at the

[383] SI 2002/1986.

heart of the American system of corporate governance.[384] Other commentators believe that the market for corporate control provides a useful backup mechanism for when the others fail.[385]

The Market for Corporate Control.

The issue that now preoccupies us is how can the hostile takeover bid improve standards of corporate governance. The theory is as follows:

> If a company is being operated below its true potential, shareholders, dissatisfied with the returns they are obtaining, will sell their shares. If they divest in significant numbers the price of the company s shares will fall. Observers of the market will conclude that the company s shares are trading at a discount because of the inadequacies of its current managers. This acts as a signal to one or more rival management teams who will respond by mounting a bid to buy the company s shares from their existing owners with a view to unlocking the profitability that the current management is failing to extract. Having obtained control of the company the successful bidder will replace the board with its own appointees and make the necessary changes to improve efficiency.[386]

The practical effect of the market for corporate control is that it transfers corporate assets to those who can make optimal use if them.[387] However, the theory goes further in that a takeover need not occur in order to encourage improved standards of governance. The mere existence of the *threat* of a takeover may ensure that directors keep profitability high as in order to ward off takeovers, they will need to keep share prices high.[388] As two prominent commentators note:

> A robust market for corporate control improves managements performance because incumbents inevitably prefer to reduce the probability that an outside bid will be made. Incumbent management will be unsure how much better a particular rival management team is; consequently, management will be unsure how far the firm s share price must fall before attracting a hostile bid. This

[384] J.R. Macey and G.P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan and the United States* (1995) 48 Stan. L. Rev. 73 at 101.
[385] R.A. Romano, *A Guide to Takeovers: Theory, Evidence and Regulation* (1992) 9 Yale J. on Reg. 119 at 129.
[386] J. Parkinson, *Company Law and Stakeholder Governance* in G. Kelly, D. Kelly & A. Gamble (eds.), *Stakeholder Capitalism*, 1997, Macmillan Press Ltd., p.145.
[387] J. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.119.
[388] See DTI, *Mergers Policy: A Department of Trade and Industry Paper on the Policy and Procedures of Merger Control*, 1988, London: DTI, para.2.27: The Government believes that the threat of take-over is a powerful spur towards efficiency in the management of UK companies.

> uncertainty creates an incentive for managers to improve a firm s performance, *even if a hostile offer never actually materializes.* [389]

The Market for Corporate Control in Practice.

This forms the theoretical underpinnings of the market for corporate control. However, for numerous reasons, this theory does not work so well in practice. To these reasons we now turn.

The Efficient Capital Market Hypothesis.

The effectiveness of the market for corporate control is based on the proposition that the company s share price is an indicator of corporate performance. As information disseminates into the market, it affects the share price. This proposition has been termed by financial economists as the Efficient Capital Market Hypothesis (ECMH).[390] The ECMH is therefore vital for the market for corporate control to be effective for if it was not, there would be considerable scope for take-overs based on speculative and other motives where corporate control changes hands because of differences in information, or of opinion about the accuracy of stock market valuations, between sellers and purchasers of control, rather than because of proposed changes in management objectives or operating efficiency. [391] Accordingly, the effectiveness of the ECMH needs to be analysed.

Three versions of the ECMH have been tested: the weak form, the semi-strong form and the strong form. The market is efficient in the weak sense if prices fully reflect all information contained in past share prices. Empirical evidence suggests that stock markets are efficient in this sense, since share price movements are generally independent of prior fluctuations. Consequently, studying past share price fluctuations will not enable investors to beat the market and obtain abnormal returns.[392]

[389] J.R. Macey and G.P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan and the United States* (1995) 48 Stan. L. Rev. 73 at 104 (italics added).

[390] For a more detailed analysis of the ECMH, see S.M. Keane, *Efficient Markets and Financial Reporting*, 1987, Edinburgh: ICA of Scotland.

[391] A. Hughes, *The Impact of Merger: A Study of Empirical Evidence for the UK* in J.A. Fairburn and J.A. Kay (eds.), *Mergers and Merger Policy*, 1989, Oxford: OUP, p.33.

[392] *Cf. The Mathematics of Markets (Survey of the Frontiers of Finance)* (1993) *Economist*, 9th October who argues that computer studies of trading patterns is a viable strategy to predict market movements.

A market is efficient in the semi-strong sense if share prices reflect all publicly available information. Testing this form of the ECMH is done by using event studies. These are carried out by examining the response of share prices to public announcements of notable occurrences such as takeover bids, changes in dividend policy and dismissals of senior executives.[393] These tests indicate that share prices adjust rapidly to reflect this information. Accordingly, the market appears to be efficient in the semi-strong sense.

Finally, a market is efficient in the strong sense if share prices fully reflect all knowable information, be it publicly available or not. Immediately, one can be forgiven for being sceptical regarding this form of the ECMH as it states that information known only to senior executives is somehow in the market. Empirical evidence confirms this scepticism. If share prices reflected all information, it would be impossible for senior executives to partake in insider trading. Instead under the strong ECMH, the share price would react instantly to the information that the insiders would try to rely on. There is no doubt, however, that insiders can obtain significant abnormal returns by utilising confidential, price-sensitive information. It is therefore apparent that the market is not efficient in the strong sense of the ECMH.

It would therefore appear that the market operates in accordance with the semi-strong form of the ECMH. This would indicate that, in the main, the ECMH contention is largely correct and that share price does reflect corporate performance. However, there are a number of reasons why this might not always be the case.

Firstly, if trading in a company s shares occurs only rarely or in a small volume, it is unlikely that the share price will be efficient in the semi-strong sense. This is because the market professionals who have the ability and resources to detect mispricing will not be studying the company and therefore will not be performing the price-setting function that they will with companies that have well-traded shares.[394] The practical

[393] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.56.
[394] *Ibid.*

implications of this are that the ECMH will not apply to all stock markets, or to all shares listed for trading on a single stock market.[395]

Secondly, describing the share price as efficient may be misleading in that it infers that it is a reliable indicator of future net cash flows. There are several reasons to doubt such an inference. Notably, if there are relevant price-sensitive facts of which only the corporate insiders are aware, this will not be reflected in the share price. Further, even if all information is in the market, future events that can affect a company are still unknown. Accordingly, a company s share price cannot be a reliable indicator of future performance.[396]

Finally, the assumption that the share price is a reliable indicator of the company s future value is rested on the presumption that investors buy and sell equity on the basis of future net cash flows. This assumption is not always correct. Investors may instead invest on the basis of other factors collectively referred to as noise.[397] An example of noise-trading is where investors were acting as trend-chasers. This is where investors, instead of examining the underlying value of companies, get caught up in a wave of market sentiment and buy shares even though there has been a sustained rise in price or sell shares after prices have been falling for a period of time. Empirical evidence backs up the existence of such noise-trading on both the London and New York stock exchanges.[398] This means that markets can overreact to dramatic events which will of course result in inaccurate share pricing and so will reduce the effectiveness of the ECMH. Given this, it may be possible to make abnormal profits

[395] R.J. Daniels and J.G. MacIntosh, *Toward a Distinctive Canadian Corporate Law Regime* (1991) 29 Osgoode Hall LJ 863 at 877-8.
[396] The true issue here is whether markets are fundamentally efficient or informationally efficient. On this, see I. Ayres, *Back to Basics: Regulating how Corporations Speak to the Market* (1991) 77 Va.L.Rev. 945 at 968-75 and G.P. Miller, *Fraud-on-the-Market Theory Revisited* (1991) Va.L.Rev. 1001 at 1012-4.
[397] See W.K.S. Wang, *Some Arguments that the Stock Market is Not Efficient* (1986) 19 UC. Davis L.Rev. 341 at 344-8 and A. Schleifer and L.H. Summers, *The Noise Trader Approach to Finance* (1990) 4 J. of Econ. Perp. 19.
[398] M. Kahan, *Securities Laws and the Social Costs of Inaccurate Stock Prices* (1992) 41 Duke LJ 977 at 990-2 and T.L. Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law* (1991) 70 NC.L.Rev. 137 at 144-7.

by betting that noise-traders will overreact and pay too much for shares or sell them at too low a value.[399]

Takeovers and Transaction/Social Costs.

A significant obstacle to the operation of the market for corporate control are the transaction costs of acquiring control of a company. It was estimated that the total fees paid to third parties in the takeover process in the UK in 1985 amounted to £500 millions.[400] By 1989, this figure was over £800 millions for *financial advice alone*.[401] There are numerous examples of failed bids that have cost the company dearly: the abortive Elders IXL bid for Allied Lyons in 1986 cost the bidder £30 millions and the target £14 millions; underwriting, professional fees and advertising cost Argyll nearly £50 millions in their unsuccessful bid for Distillers in 1985 and, finally, the abortive consortium bid by Hoylake for BAT is reputed to have cost £140 millions.[402] These figures do not take into account the premium that will have to be paid to acquire the target s shares.

These costs are likely to act as a significant disincentive to any company wishing to engage in takeover activity. Anything which increases the costs of acquiring control of a company interferes with the market for corporate control because a rational predator will balance the costs of a takeover against the prospective benefits to be derived.[403] In order for the market for corporate control to work, the predator must be able to acquire control of the target company for less than the profit it will make by remedying the existing management s inefficiency to the company. [404] If the costs are too substantial, and indications are that they can be, a rational predator will not takeover an inefficient company. Accordingly, these transaction costs can provide a

[399] See *Yes, It Can Be Done* (1992) *Economist*, 5th December. On whether this herding behaviour which should arise with trend-chasing actually occurs, see W. Christie and R.D. Huang, *Following the Pied Piper: Do Individual Returns Herd Around the Market?* (1995) *Financial Analysts Journal*, July-Aug, 31.

[400] J.A. Kay, *The Role of Mergers*, 1986. Institute of Fiscal Studies Working Paper 94 quoted in J. Franks and R. Harris, *Shareholder Wealth Effects of UK Takeovers: Implications for Merger Policy* in J.A. Fairburn and J.A. Kay (eds.), *Mergers and Merger Policy*, 1989, Oxford: OUP, pp.169-70.

[401] J. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries*, 1995, Oxford: OUP, p.311.

[402] A. Peacock and J. Bannock, *Corporate Takeovers and the Public Interest*, 1991, Aberdeen: Aberdeen University Press, p.13.

[403] D.R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers* (1978) 57 Tex. L. Rev. 1 at 26.

[404] C. Bradley, *Corporate Control: Markets and Rules* (1990) 53 MLR 170 at 172.

barrier behind which inefficient management can hide. One commentator has concluded that the cost of acquiring control is so great that the disciplinary force of the market is likely to be limited to instances of gross managerial failure. [405]

The existence of a market for corporate control can also result in increased social costs. As we shall see, the market for corporate control can result in the transfer of funds from long-term investments to appease short-term shareholder interests. Accordingly, the public interest may be harmed due to research that was not undertaken due to the existence of a market for corporate control. Some acquisitions result in an increase in the level of debt of the combined enterprise. This may in turn jeopardise the position of the company s creditors. Finally, if, through predator behaviour, a company significantly increases its power in the market within which it operates, it may engage in monopolistic behaviour. This may result in goods of lower quality, an increase in the price of its goods or an increase in the time that it takes to pay its creditors. Such actions could be harmful to consumers and suppliers.

Predator Behaviour.

Commentators argue to a greater or lesser degree that all companies are potential targets. As Charkham has noted [t]here is nothing cut and dried or mechanistic about bids except, to repeat, that every company has its price. [406] Predator behaviour, according to the market for corporate control, is the mechanism that serves to displace inefficient management. However, in practice, it may be used by management as a means to ward off potential takeover bids. Empirical evidence suggests that the most effective takeover defence for a company is to increase its capitalisation by itself becoming a predator.[407] For example, P & O, in the space of two years, increased its market capitalisation from £300 millions to £1.6 billion through a policy of mergers.

[405] J.C. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer s Role in Corporate Governance* (1984) 84 Colum.L.Rev. 1145 at 1200. Another survey indicated that a company s shares will need to fall 13% below their potential before there is a significant risk of a takeover: R. Smiley, *Tender Offers, Transaction Costs and the Theory of the Firm* (1976) 58 Rev. of Econ, and Stats. 22.

[406] J. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries*, 1995, Oxford: OUP, p.310.

[407] *E.g.* Singh, *Take-overs: Their Relevance to the Stock Market and the Theory of the Firm*, 1971, Cambridge: Cambridge University Press; Mueller, *The Determinants and Effects of Mergers. An International Comparison*, 1980, Cambridge. Mass.: Oelgeschlager, Gunn & Hain, Publishers Inc and Mueller, *The Modern Corporation. Profits, Power, Growth and Performance*, 1986, Lincoln: University of Nebraska Press.

Accordingly, in some instances, the management in promoting a policy of growth through acquisition as opposed to organic growth can be seen to be acting in a self-serving sense rather than in the interests of the investors.[408] Given this, it has been argued that management is not competent to make this type of business decision.[409]

The form of predator behaviour can actually increase the scope of managerial inefficiency. If a company becomes a predator in order to insulate itself from potential takeover bids, and the management is inefficient, then this will simply result in more assets being controlled by the ineffective management. Growth motivated purely for defensive reasons are economically damaging by-products of an active market for control, [410] causing a huge diversion of managerial effort into devising ways to reduce a vulnerability that did not grow out of managerial inefficiency. [411]

However, there is evidence to suggest that the defensive advantages of size are being eroded. Changes in financing methods, particularly a trend towards paying for acquisitions with borrowed money, and the emergence of consortium bids, have resulted in increased predatory purchasing power.[412]

More significantly, in recent years, evidence has started to suggest that large conglomerates are subject to an increased threat of break-up or demerger acquisitions.[413] Management may become predatory in order to protect themselves and their companies from the threat of takeover, but at some point the conglomerate produced by these acquisitions, becomes vulnerable to the threat of a demerger takeover, which suggests that the acquisitions which created the conglomerate in the first place failed to increase efficiency.[414] In terms of increased efficiency, break-up

[408] C. Bradley, *Corporate Control: Markets and Rules* (1990) 53 MLR 170 at 174-5.
[409] G.W. Dent Jnr., *Unprofitable Mergers: Towards a Market Based Legal Response* (1986) 80 NWUL Rev. 777 at 782.
[410] J. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.128.
[411] Herman and Lowenstein, *The Efficiency Effects of Hostile Takeovers* in J.C. Coffee *et al*. *Knight, Raiders and Targets*, 1988, Oxford: OUP, p.215.
[412] See Chiplin and Wright, *The Logic of Mergers*, 1987, London: IEA, pp.14-8, 58-61 and C. Moir, *The Acquisitive Streak*, 1986, London: Hutchinson Business, pp.122-23.
[413] *E.g. Takeover Activity in the 1980 s* (1989) February, *Bank of England Quarterly Bulletin* 78 at 79; Coyne and Wright (eds.), *Divestment and Strategic Change*, 1986, Oxford: Phillip Allen Publishers Ltd. and Wright, Chiplin and Coyne, *The Market for Corporate Control: The Divestment Option* in Fairburn and Kay (eds.), *Mergers & Mergers Policy*, 1989, Oxford: OUP.
[414] C. Bradley, *Corporate Control: Markets and Rules* (1990) 53 MLR 170 at 175.

takeovers seem to be desirable since they are an instance when the market for corporate control reasserts itself. However, takeovers, as we have seen, involve substantial transaction costs and so it would be preferable that takeovers that do not increase efficiency did not occur in the first place.

The Economic Effect of Takeovers.

We have seen that according to the theory, the beneficial effect of the existence of a market for corporate control is that efficient management displaces inefficient management. Accordingly, one would expect that a change in management by takeover would result in an increase on the firm s profitability. Recently, empirical research in this area has increased enabling us to assess the validity of the efficiency justification behind the market for corporate control. As we shall see, the evidence suggests that certain presumptions held by the market for corporate control may be doubted. Notably, however, the efficiency justification seems to be evident in practice and so it is this we will examine first.

Loughran and Vijh in 1997 studied a large sample of takeovers in the US between 1970-1989.[415] They measured the returns to shareholders of the target during the announcement period and up to five years after the consummation of the merger/takeover. They found that after five years the returns to shareholders in merging firms had hardly changed from 25.8% to about 30%. However, the returns to shareholders in companies that were taken over improved dramatically from 24.5% to 127%. The author s explanation for the difference was that tender offers, which are often hostile to incumbent managers, may create additional value as new managers are appointed. In the case of mergers, that are friendlier and enjoy the co-operation of incumbent management, the additional value creation is less likely to occur. [416]

This study appears to agree with the theory underpinning the market for corporate control, namely that companies perform more efficiently post-takeover. However, this study only examined the position of the target company and so only gives a partial justification. We also need to examine the position of the bidder. In 1996, this

[415] T. Loughran and A.M. Vijh, *Do Long Term Shareholders Benefit from Corporate Acquisitions* (1997) Journal of Finance 1780.
[416] *Ibid.* at p.1787.

was done by Higson and Elliot[417] who examined the performance of a large sample of UK takeovers between 1975-1990. They found that bidder earned abnormal returns of about 0.43-1.3%. Accordingly, substantial gains are to be made but they almost entirely accrue to the target.

However, the market for corporate control is largely concerned with the position of the target. Therefore, the efficiency justification is largely affirmed. However, the assumptions upon which it is based are debatable.

The efficiency justification is based on the premise that potential targets are under-performing. However, the evidence does not confirm this. In 1996, Franks and Mayer studied 80 hostile takeover bids in the UK in 1985-1986.[418] They found that there was little evidence to support the conclusion that the targets of hostile takeovers were below average performers prior to the bid. For example, over the five years prior to the bid, companies that were successfully taken over had shareholder returns of -0.14%. However, the returns of matching companies that were not targets only appreciated by 0.14%. The difference is almost negligible. Both sets of firms had returns that were practically zero. The same authors used another benchmark to validate this conclusion, namely the payment of shares. Again, this indicated that the target firms were not under-performing. They found that a majority of the target firms increased their dividends during the two years prior to the bid, and only 8% of target firms reduced or omitted a dividend in the year prior to the bid.

So while the efficiency justification of the market for corporate control seems to be upheld, the motivating factors behind takeovers seems to be in doubt. In fact, it is generally accepted that takeovers occur for reasons other than ineffective management. As we shall see, takeovers occur for a variety of reasons.

Firstly, ignoring any actual motive, the occurrence of takeovers seems to be dependant on economic climate and so tends to be cyclical. For example, many academics perceive the 1980s as a decade of unparalleled merger and takeover

[417] C. Higson and J. Elliot, *Post-Takeover Returns: The UK Evidence* (1996) 58 Journal of Empirical Finance 1.

activity. However, this perception appears to be inaccurate as the Fortune 500 noted in 1997:

> Like a lot of people, you may still think of the 1980s as the era of merger mania. Well, wake up: Today s mergers and acquisitions make the 80s look small-time. The global M&A market broke all records lat year at $1 trillion and at its current pace will hit $1.3 trillion this year. (The biggest year of the 80s was 1989: $600 billion.) [419]

Secondly, and more importantly, there is a wealth of reasons why a company may wish to takeover another. It may even be the case that inefficient companies are not favourable targets. A US survey carried out in 1981 considered that the feature that made a company most attractive to takeover was that it had excellent management and the majority of respondents agreed that managerial inefficiency would actually deter them from making a bid.[420] This has been borne out in practice. Nestl bought Rowntree because its management had been good, not bad. When Deutschebank took over Morgan Grenfell, it gave the Morgan Grenfell head a major role and a seat on the Vorstand in recognition of his abilities.[421] Other reasons for a takeover include diversification, access to new markets, increasing a market share, to reduce competition or to acquire the benefits of economies of scale.

This has a worrying consequence as regards the market for corporate control. If managerial ineffectiveness is not a major concern when entering the market for corporate control, it can be assumed that badly managed companies are no more at risk than well-managed ones; in fact, as we have seen, many bidders prefer their targets to be well-managed. This serves to significantly reduce the disciplinary effect of the market for corporate control.[422] As one commentator has stated [s]ince takeovers appear to have no systematic impact on weak management or suboptimal resource use takeover threats cannot affect management behaviour except in an

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[418] J. Franks and C. Mayer, *Hostile Takeovers in the UK and the Correction of Managerial Failure* (1996) 40 J. of Fin. Econ. 163.

[419] Quoted in K. Gugler (ed.), *Corporate Governance and Economic Performance*, 2001, New York: OUP, p.32.

[420] See J.C. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer s Role in Corporate Governance* (1984) 84 Colum.L.Rev. 1145 at 1212.

[421] J. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries*, 1995, Oxford: OUP, p.311.

[422] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.123.

inconsistent manner. If doing well is no protection, the incentive to avoid doing badly is weak. [423]

Despite this, there is still a presumption by management that if a company s share price is not kept high, the company will be vulnerable to a takeover. If managers are concerned with the immediate share price, this will necessarily involve a reduction in long-term investment. In other words, the market for corporate control is another factor that contributes to the UK economic problem of short-termism. Many CEOs will state that their strategic policy is not influenced by a fear of a takeover. Yet as has been pointed out no CEO ignores his share price. [424]

Evidence backs this up. In the fourth quarter of 1989, at the height of the 1980s takeover boom, the dividend pay out ration had reached an unprecedented 62%. The Bank of England noted that there is quite substantial empirical evidence that the growth in dividend payments has been strongly associated with the boom in hostile bids. [425] This unprecedented dividend pay out took place in a year in which the corporate sector s financial deficit was £24 billions and indebtedness to banks rose by £33 billions.[426] One commentator has written [t]he monetary squeeze has been tighter for longer as companies have borrowed to pay dividends: and when the recession comes it will be amplified by higher than needed cuts in investment and workforce so that dividends, having reached ever higher levels do not suffer. [427] In other countries where market pressures are not so severe, dividends are not so important. For example, in Germany and Japan, shareholders receive relatively small dividends. Conversely, in the UK, the market pressures caused by a fear of takeovers has caused shareholders to be paid more than is good for the long-term health of the company. This point was made by the Financial Times in 1992 when it stated [t]he result is that dividends enjoy priority in a recession over capital investment, pay and

[423] R.M. Buxbaum, *Corporate Legitimacy, Economic Theory and Legal Doctrine* (1984) 45 Ohio State LJ. 516 at 531.
[424] J. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries*, 1995, Oxford: OUP, p.312.
[425] See W. Hutton, *Takeover Legacy Has Touched Us All at Great Cost* (1990) *Financial Times* 3rd September.
[426] J. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries*, 1995, Oxford: OUP, p.313.
[427] W. Hutton, *Takeover Legacy Has Touched Us All at Great Cost* (1990) *Financial Times* 3rd September.

jobs. German corporations by contrast operate on the reverse set of priorities with dividends coming bottom. Ominously, and in a passage that resonates strongly with the UK takeover experience, Adam Smith in the final chapter of book 1 of The Wealth of Nations noted that the rate of profit is naturally low in rich and high in poor countries, and it is always highest in the countries which are going fastest to ruin. [428]

The Effect of Takeovers on Stakeholders and Implicit Contracts.

On a theoretical level, there is a general presumption amongst commentators that shareholders benefit from takeover activity whereas takeovers inflict significant losses on stakeholders. This has led some to conclude that takeovers bring about a redistribution of wealth from the stakeholders to the shareholders. Again this would be consistent with the philosophy behind the legal model of the company. However, a number of recent studies have found that this presumption of stakeholder loss may not be entirely accurate.

The most common stakeholder associated with takeover losses are the employees. Many commentators assume that following a takeover, job losses and wage cuts will follow. However, empirical studies investigating the effect of takeovers, mergers and acquisitions on labour do not provide convincing evidence for the widely held belief that employees do suffer losses in these situations. Brown and Medoff examined employment and wage data on over 200,000 Michigan firms over a 26-month period. They found that, although mergers were associated with a wage decrease of 4%, employment in the same firms actually increased by 2%.[429] Conversely, asset-only acquisitions were associated with employment reductions of 5% but with wage increases of 5%.[430] These results led the authors to conclude that the common public perception that acquisitions provide the occasion to slash wages and employment finds little support. [431] Similarly, Yago examined the correlation between lay-offs and leveraged buy-outs (LBOs) during 43 LBOs concluded between 1984-86. He

[428] A. Smith, *The Wealth of Nations*, 1986, Harmondsworth: Penguin Classics.
[429] C. Brown and J. Medoff, *The Impact of Firm Acquisitions on Labour* in A. Auerbach (ed.), *Corporate Takeovers: Causes and Consequences*, 1988, Chicago: Chicago Press, p.22.
[430] *Ibid.*
[431] *Ibid.* at p.23.

found that on an average means basis, LBO firms reversed patterns of job loss prior to ownership change and increased employment after the buyouts. [432]

Another common non-shareholder constituent assumed to suffer during takeover activity are the creditors. For creditors, the loss from a takeover transaction will come from the wealth losses from depreciated debt. Any event that increases the default risk (the risk that the creditors will not be paid) can result in credit devaluation. This increase in risk will be reflected in an increase in the size of the discount necessary to entice other individuals to purchase the debt instrument. The greater the decrease, the greater the creditor s loss.

However, there exists empirical evidence that both agrees with and refutes the contention that creditors suffer loss. Early studies indicated that takeover activity did not have a negative effect on creditors. Kim and McConnell studied monthly returns to non-convertible bondholders between 1960 and 1973 for 20 acquiror firms and 19 acquired firms and found that there were no significant gains or losses from either group upon takeover activity.[433] Conversely, later studies, which parallel the rise in more leveraged transactions, appear to support the claim that takeover activity can result in losses to creditors. For example, Crabbe points to the Nabisco LBO where shareholder gains amounted to over $12 billion whereas the creditors lost $1 billion.[434]

It is also believed that other groups can suffer losses through takeover activity, yet with these groups also, the evidence is far from conclusive. It has been said that the firm s customers will suffer through the termination of certain product lines. Yet there is no evidence to suggest that product terminations occur following a takeover.[435] It has even been stated that entire communities can be severely affected by change-of-control transactions. [436]

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[432] G. Yago, *Junk Bonds: How High Yield Securities Restructured Corporate America*, 1991, New York: OUP, p.135.
[433] See Kim and McConnell, *Corporate Mergers and the Co-Insurance of Corporate Debt* (1977) 32 J. Fin. 349.
[434] See L. Crabbe, *Event Risk: An Analysis of Losses to Bondholders and Super Poison Put Bond Covenants* (1991) 46 J. Fin. 689.
[435] R. Daniels, *Stakeholders and Takeovers: Can Contractarianism Be Compassionate?* (1993) 43 Univ. Toronto LJ. 315 at 322.
[436] *Ibid.*

Accordingly, the established contention that takeover activity results in stakeholder losses cannot be easily established, at least so far as employees and creditors are concerned (the only two stakeholder groups for which useful data is available.) Further, the contention that shareholder gains come at the expense of stakeholder losses cannot be justified. In those instances where the stakeholders have made losses, these losses have been a tiny fraction of the shareholder gains. Therefore, the contention that takeovers redistribute wealth from the stakeholders to the shareholders must also be doubted.

Conclusion.

The empirical evidence seems to suggest that the takeovers are beneficial for shareholders (more so for target shareholders as opposed to bidder targets.) Hostile takeovers are even more profitable, a fact which can be attributed to a willingness to change management. However, the targets of hostile takeovers do not show evidence of being poor performers. Target companies appear to be average or slightly below average performers in comparison with other quoted companies. This may be enough to establish that takeovers benefit the economy, but it is not enough to establish the existence of a strong market for corporate control. To establish that, one must demonstrate that takeovers occur in order to replace inefficient management. The empirical evidence does not support this.

We have noted that the vast majority of the internal mechanisms discussed uphold the legal model of the company by making the directors act in a pro-shareholder manner or by providing shareholders with some form of protection. The market for corporate control, although an external form of governance, also upholds the legal model of the company. In fact, the takeover market is probably the most overt mechanism that upholds the legal model, in that it places market pressures upon directors forcing them to keep the share price high. In order to do this, directors will adopt a policy of profit maximisation, which is the goal of the company under the legal model. Accordingly, the market for corporate control forces the directors to uphold the legal model of the company or risk being replaced by management who will.

CONCLUSION.

The purpose of this chapter has been twofold. The first purpose was to demonstrate that the various corporate governance mechanisms in this country offer only weak sources of accountability. In Part I, we saw how the AGM s effectiveness has been weakened by the various procedural rules that govern it and the practical difficulties of co-ordinated shareholder activism. Part II examined the possibility of a new era of accountability through the efforts of institutional investors. However, we also saw that there are a number of practical barriers that make this possibility unlikely. The effectiveness of NEDs was examined in Part III and severe doubts expressed as to their ability to effectively monitor management. Despite the recommendations of Cadbury and the Combined Code being almost universally adopted, behind the scenes executive influence still ensures that NEDs are not the independent monitors that they should be. Part IV examined the various mechanisms in place designed to regulate executive pay. Again, as with NEDs, despite the various self-regulatory recommendations being almost universally followed, executive influence ensures that the various remuneration mechanisms, notably the remuneration committee, are flawed. Finally, in Part V, we noted that the aforementioned internal mechanisms provide limited accountability and so we tend to rely on an external mechanism, namely the hostile takeover market. However, we also saw that the effectiveness of the market for corporate control as a disciplinary mechanism must be doubted.

The second aim of this chapter was to demonstrate that the limited pressures the above mechanisms impose all aim to make the directors comply with the legal model of the company, in that they either make the directors act in a profit maximising way or give the shareholders some way to attack the directors if they do not act in a profit maximising way. The AGM is the primary, if not the only, mechanism whereby the shareholders can communicate their wishes and queries to management. Stakeholders play no part in the AGM. Institutional investors will have the same concerns and desires as normal investors and so they will pressure directors to maximise profits. The various remuneration schemes in place are supposedly to be based on linking pay to performance, so that directors pay will rise if the share price is high. In order to keep the share price high, directors will adopt a policy of profit maximisation. Finally, the limited market pressures imposed by the hostile takeover market require directors to keep the share price high, and once again this will be achieved by a policy of profit maximisation.

The above discussion has focused on the formal mechanisms of corporate governance, but increasingly, informal mechanisms are starting to play an increased role. The main form of informal mechanism concerns self-regulatory Codes and non-governmental bodies. The actual effectiveness of these informal measures will not be examined here as this chapter is concerned with formal mechanisms. However, their impact upon the stakeholder debate is worth mentioning given that they appear to espouse the same approach as the formal mechanisms *i.e.* they uphold the legal model of the company. The various codes to date have stated little on the stakeholder debate. However, in 1998, the Committee on Corporate Governance (informally known as the Hampel Committee) did say that [t]he single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders investment.[437] So even though, the actual content of the self-regulatory reports says little on the stakeholder debate, it appears that the committees that draft these reports firmly believe in the ethos behind the legal model.

Accordingly, the conclusion regarding the various corporate governance mechanisms in place in the UK must be that they provide only a limited source of accountability and impose upon directors weak pressures, and what pressures they do impose are firmly in line with the goals of the legal model of the company.

[437] *The Report of the Committee on Corporate Governance*, 1998, London: Gee Publishing Ltd., para. 1.16.

6

Examining the Legal Model of the Company: Profit Maximisation and Exclusive Shareholder Governance Protection

Introduction.

One of the aims of corporate governance is to bring about accountability and transparency. Company law should provide for a system whereby companies should be free to partake in risk-taking activity that can enhance societal wealth but at the same time, they should do it in such a way that encourages transparency in order that the regulatory authorities can ensure that corporations adhere to their legal requirements as well as providing interested parties with information concerning the company. This is the *raison d etre* of company law. However, bearing this in mind, consider the following description of a large multinational company:

> Exxon is a typical corporate giant. Like the hundred or so corporations with assets of at least $1 billion and, in combination, the lion s share of America s industrial profits and earnings, Exxon does not really sell the products that produce its mind-boggling revenues. Its oil, chemicals, electronic typewriters, and motors are actually sold by an array of companies that Exxon owns . Most remarkable about Exxon s empire, however, is its scope. It operates in nearly 100 countries. Its 195 ocean-going tankers, owned and chartered, constitute a private navy as big as Britain s. [1]

In 2000, Exxon Mobil had revenues of $163.9 billions.[2] This figure is larger than the gross domestic product of 161 countries, including Israel, Poland and Greece.[3] Exxon is not even the largest corporation in the world - General Motors has revenues of over $189 billions. Of the 100 largest economies in the world, only 49 are countries; the rest are corporations.[4] It is difficult to reconcile notions of accountability with entities of this size and power. This may go some way to explain why profit maximisation has held such a well established place as a yardstick for corporate accountability. In Chapter 1, we saw that Berle noted that one of the main objections to stakeholder ideologies is that, to date, they have not provided an accurate enough means of

[1] W.H. Shaw & V. Barry, *Moral Issues in Business*, 1995, 6th ed., Belmont, California: Wadsworth Publishing Co., pp.199-200.
[2] See *The Fortune 1000 List* [Online] Available http://www.fortune.com/fortune/fortune500 27th September 2000.
[3] S. Anderson and J. Cavanagh, *Top 200: The Rise of Global Corporate Power* [Online] Available http://www.corpwatch.org trac/corner/glob/ips/top200.html 25th September 2000.
[4] *Ibid.*

accountability. This is one of the main attractions of the legal model. Acting in the interests of the shareholders means keeping the share price high. In order to keep the share price high, consistent dividends need to be paid. In order to pay consistent dividends, profit must be maximised. The goal of profit maximisation carries with it the benefit of being easily quantifiable. Therefore, adherence to the legal model provides an easy means of accountability.

However, this is not enough to justify a policy of profit maximisation. Part I will look at the various economic rationales for adopting a policy of profit maximisation. It will be seen that none of the modern justifications are longer sufficient to justify a profit maximising approach.

The adoption of the legal model not only requires adopting profit maximisation as the corporate goal. It also requires that our company law be pro-shareholder. In fact, total adherence to the legal model requires that our company law protect shareholders exclusively. The various justifications for exclusive shareholder governance protection will be examined in Part II and will form the basis of the justifications for stakeholder protection in Chapter 7 and for environmental protection in Chapter 9.

I. THE JUSTIFICATIONS FOR PROFIT MAXIMISATION.

As noted above, the legal model requires that companies act in the interests of shareholders *i.e.* in a profit maximising manner. Over the years, a number of arguments have arisen that seek to justify this pro-shareholder approach or more specifically contend that corporations should not engage in socially responsible, profit sacrificing activity.

The Efficiency Argument.

In 1962, Milton Friedman famously wrote:

> The view has been gaining widespread acceptance that corporate officials and labor leaders have a social responsibility that goes beyond serving the interest of their stockholders or their members. This view shows a fundamental misconception of the character and nature of a free economy. In such an economy, there is one and only one social responsibility of business-to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud Few trends could so thoroughly

> undermine the very foundation of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible. [5]

This is the essence of the efficiency argument. Societal wealth, and consequently societal well being, is maximised only if companies engage in activities that accrue profit. The function of business is to produce sustained high-level profits. The essence of free enterprise is to go after profit in any way that is consistent with its own survival as an economic system. [6] Accordingly, if companies depart from the profit goal and engage in what they believe to be social responsible behaviour, then they are in fact producing sub-optimal societal outputs. In essence, the socially responsible thing to do is to increase profits.[7] For example, if a plant becomes unprofitable then, according to the efficiency argument, the socially responsible thing to do would be to close it down. The company may think that it is behaving in a socially responsible manner by keeping the plant going by diverting funds from elsewhere, but those funds would not be yielding their full return and so, ultimately, society would suffer a net loss.[8] Therefore, according to this theory, it would be wrongful to ask a corporation to do something which would fly in the face of its members wishes, such as looking after the interests of the unemployed, just as it would run counter to our understanding of liberty and freedom to impose positive duties on human individuals to act altruistically towards others. [9]

Linked to this idea that proactive social activity that departs from the profit goal is actually socially inefficient are two further criticisms. Firstly, as noted, in a free market system, a company s function is to make a profit. If managers depart from this function to pursue social projects, they are diverting managerial time and effort away from the company s legitimate activities.[10] Secondly, expenditure on socially responsible goals could actually reduce societal well being through a loss in investor

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[5] M. Friedman, *Capitalism and Freedom*, 1962, Chicago: University of Chicago Press, p.133.
[6] T. Levitt, *The Dangers of Social Responsibility* in H.D. Marshall (ed.), *Business and Government: the Problem of Power*, 1970, Lexington, Massachusetts: D.C. Heath and Company, p.26.
[7] This, of course, is the thesis of Friedman s famous slogan the social responsibility of business is to increase its profits. See M. Friedman, *The Social Responsibility of Business is to Increase its Profits* (1970) *New York Times Magazine* September 13th.
[8] F.A. Hayek, Law, *Legislation and Liberty* Vol.3, 1982, London: Routledge, pp.81-2.
[9] H.J. Glasbeek, *The Corporate Social Responsibility Movement-The Latest in Maginot Lines to Save Capitalism* (1988) 11 Dalhousie LJ. 363 at 371.
[10] T. Levitt, *The Dangers of Social Responsibility* in H.D. Marshall (ed.), *Business and Government: the Problem of Power*, 1970, Lexington, Massachusetts: D.C. Heath and Company, pp.35-6.

confidence. Social expenditure lowers profits, thereby reducing the attractiveness of equity investments bringing about an increase in the cost of capital and a concomitant reduction in business activity.[11]

Some critics have gone even further in their condemnation of social activity that departs from the profit goal. They argue that the making of profit, not social sentiment, lies at the heart of a capitalist system[12] and to depart from profit is to shake the foundations of capitalism itself. [A]s the profit motive becomes increasingly sublimated, capitalism will become only a shadow-the torpid remains of the creative dynamism which was and might have been. [13]

Accordingly, the thesis of the efficiency argument is that profit is the legitimate social aim of the corporation and to depart from this is to be socially irresponsible. However, there are reasons to doubt this contention. It can be demonstrated that certain perceived profit maximising techniques are ultimately non-profitable and in these areas, departing from this perceived profit goal can, in the long-term, prove more profitable, both from society s point of view and the individual corporations.

As we have seen, in order to maximise profits corporations will, in the absence of legal restraints, externalise their costs onto third parties. It is generally believed that by passing on their costs to third parties, corporations can lower costs and thereby raise profits. However, there are valid reasons to believe that ultimately, externalities may not raise profit. In fact, in certain circumstances, they may lower profits to such an extent that they jeopardise the company s existence.

On an efficiency level, externalities can represent a misallocation of resources. The firm does not bear the full cost for the production of the good and, therefore, will not

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[11] C.D. Stone, *Public Interest Representation: Economic and Social Policy Inside the Enterprise* in K.J. Hopt and G. Teubner (eds.), *Corporate Governance and Directors Liabilities: Legal, Economic and Sociological Analyses on Corporate Social Responsibility*, 1985, New York: Walter De Gruyter & Co., pp.123; F.H. Easterbrook and D.R. Fischel, *The Corporate Contract* (1989) 89 Colum. L. Rev. 1416 at 1447.

[12] See T. Levitt, *The Dangers of Social Responsibility* in H.D. Marshall (ed.), *Business and Government: the Problem of Power*, 1970, Lexington, Massachusetts: D.C. Heath and Company, p.35 who states [t]he governing rule in industry should be that something is good only if it pays. Otherwise it is alien and impermissible. This is the rule of capitalism.

[13] *Ibid.* at p.30.

reflect this cost in the price that it charges. Accordingly, output will be higher than the good s social cost of production resulting in the resources being devoted to its production being higher than the socially efficient level.[14] When commentators argue that corporations should be made to ensure that their costs are internalised and not externalised, they do not do so as the result of any notions of corporate social responsibility. They do so to comply with the precepts of the ideal market which requires that the true costs of production are factored into the price of a product.[15]

Even more damaging to the individual corporation than this misallocation of resources is the increased possibility of litigation that externalities bring. In examining this area, two different forms of externality can be identified; (i) the traditional externality, namely the corporation foregoing or passing on costs to the detriment of others and; (ii) product externalities which are not so much the direct passing on of costs, but rather the pursuit of profit via the manufacture of goods that increase the social costs upon society.

Product externalities are slightly more subtle than traditional externalities. Certain industries do not to a great extent externalise their costs. However, the very existence of their product increases social costs. The trade-off is simple; they produce goods that make them a profit and these products result in increased social costs. These social costs are not borne solely by the corporation, if borne by the corporation at all, but rather by everyone. In that sense, they represent a form of externality. The goods in question are usually goods that are perceived to be damaging to society. The point that individual corporations who produce these goods need to be wary of is that, in certain circumstances, the courts have started to attach liability to corporations who produce these socially detrimental product. The following examples demonstrate this.

A number of tobacco companies, mainly American companies, have been besieged by lawsuits brought by smokers who are seeking millions of dollars for illnesses and

[14] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1994, Oxford: Clarendon Press, p.311.
[15] H.J. Glasbeck, *The Corporate Social Responsibility Movement-The Latest in Maginot Lines to Save Capitalism* (1988) 11 Dalhousie LJ. 363 at 377.

deaths that they contend were brought about by smoking.[16] To date, tobacco companies have won every case,[17] but the number of cases continues to mushroom,[18] and in a few instances, tobacco companies have settled out of court. Even when these companies win, they still have to expend vast sums in representation costs. Bars, off-licenses and restaurants are being sued with increasing frequency by patrons, as well as injured third parties, when motor vehicles accidents are linked to alcohol consumption.[19] Finally, in an American decision that has stunned commentators, a handgun manufacturer was held liable to a shooting victim for selling a gun that was subsequently used in a robbery attempt.[20] The following example demonstrates how product externalities can be devastating for a corporation.

In 1982, Johns-Manville Sales Corporation voluntarily filed for reorganization under Chapter 11 of the American Federal Bankruptcy Act.[21] The reason for this reorganization was the financial burden of defending more than 15,000 lawsuits filed by former employees, or their next-of-kin, for injury or death caused by exposure to asbestos while working for the company. By 1981, the company had disposed of 1,900 claims at an average cost of $15,000 per claim and costs had risen to $21,000 per claim ($40,000 if legal expenses were included). Further, new lawsuits were being filed at over 500 per month and studies forecast at least another 32,000 likely in the future. James F. Beasley, Treasurer of Manville, predicted that the total cost of

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[16] See Kepko, *Products Liability-Can it Kick the Smoking Habit?* (1985) 19 Akron.L.Rev. 269. Lawsuits are also increasing from non-smoking employees asserting their right to a smoke-free environment. See Walsh and Wool, *Nonsmokers Rights: Shimp v New Jersey Bell Telephone* (1984) 26 Wash.U.J.Ur. & Con.Temp.L. 211 and Note, *Nonsmokers Rights: The Employer s Dilemma* (1984) (1984) 28 St. Louis U.L.J. 993.

[17] See *e.g.*, Note, *Plaintiff s Conduct as a Defence to Claims Against Cigarette Manufacturers* (1986) 99 Harv.L.Rev. 909; Reskin, *Cigarettes Aren t Unreasonably Dangerous: Roysdon v R.J. Reynolds Tobacco Co.* (1986) 72 A.B.A.J. 92 and Campion, *Third Circuit Reverses Key Tobacco Ruling* (1986) 117 N.J.L.J. 3. Although, no tobacco company has lost a case, there have been settlements worth hundreds of millions of dollars.

[18] See *Tobacco Firms Defend Smoker Liability Suits with Heavy Artillery* (1987) *Wall St.J.* April 29th at 1, and *RJR Nabisco Might Encounter Big Obstacles if it Seeks to Repackage its Tobacco Business* (1987) *Wall St.J.* March 2nd at 45.

[19] See Comment, *Imposition of Liability on Social Hosts in Drink Driving Cases: A Judicial Response Mandated by Principles of Common Law and Common Sense* (1986) 69 Marq.L.Rev. 251 and Tacium, *Liquor and Liability: The Social Host* (1985) 15 Manitoba L.J. 105.

[20] *Kelley v R.G. Industries Inc.*, 304 Md. 124, 497 A.2d 1143 (Md. Ct. App. 1985), 44 A.L.R. 4th 563. See Dana, *Tort Law: Handgun Manufacturer Liability* (1986) 9 Harv.J.L. & Pub.Pol. 764 and Jett, *Do Victims of Unlawful Handgun Violence Have a Remedy Against Handgun Manufacturers: An Overview and Analysis* (1985) U.Ill.L.Rev. 967.

[21] See Note, *The Asbestos Bankruptcy: Johns-Manville s Petition for Reorganization Under Chapter 11 of the Bankruptcy Code-A Good Faith Filing or a Sham?* (1985) 19 Suffolk U.L.Rev. 55.

the litigation over the next 20 years would be at least $2 billions.[22] The Chapter 11 reorganization automatically suspended further proceedings and temporarily halted the filing of new lawsuits against Manville.

A report in 1964, prepared by Dr. Irving J. Selikoff, indicated that as early as 1929, and certainly during the 1930 s, Manville s management was aware of the potential health hazards of working with asbestos.[23] Indeed, in one Canadian plant, the medical director knew that seven employees had been diagnosed with asbestosis but decided not to tell them.[24] Nevertheless, the company decided not to take any protective measures. In effect, Manville had externalised the cost of that decision onto its employees. The financial cost it saved was passed onto them in the form of a social cost, ergo it was an externality. However, it was noteworthy that even though Manville decided not to afford its employees any special protection, it was not actually acting in violation of any State or Federal laws. In fact, at the time, there were no special safety standards required for those working with asbestos.[25]

This example is important because it shows that courts may be willing to impose heavy penalties upon corporations who try to make a profit at the expense of society. Two reasons indicate this willingness. Firstly, the court was willing to make Manville liable in a large number of lawsuits even though Manville had not actually broken any

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[22] These figures were taken from R. Buchholz, *Management Responses to Public Issues*, 1985, pp.322-35.

[23] See I.J. Selikoff *et al*, *The Occurrence of Asbestosis Among Insulation Workers* (1965) 132 Ann.N.Y.Acad.Sc. 139 and *Asbestos: Who Knew What When?* (1982) *Boston Globe* October 26th at 49.

[24] The medical director justified his position thus:

> It must be remembered that although these men have the X-ray evidence of asbestosis, they are working today and definitely are not disabled from asbestosis. They have not been told of this diagnosis, for it is felt that as long as a man feels well, is happy at home and at work, and his physical condition remains good, nothing should be said. When he becomes disabled and sick, then the diagnosis should be made and the claim submitted by the Company. The fibrosis of this disease is irreversible and permanent so that eventually compensation will be paid to each of these men. But as long as the man is not disabled, it is felt that he should not be told of his condition so that he can live and work in peace and the Company can benefit by his many years of experience. Should the man be told of his condition today there is a very definite possibility that he would become mentally and physically ill, simply through the knowledge that he has asbestosis.

Quoted in W.H. Shaw & V. Barry, *Moral Issues in Business*, 1995, 6th ed., Belmont, California: Wadsworth Publishing Co., pp.24-5.

[25] Such standards were only introduced in 1970 when Congress passed the Occupational Safety and Health Act.

law.[26] Accordingly, this decision had a retrospective effect; something that is usually anathema to most courts. Secondly, the courts were willing to breach their own procedural rules in order to find liability. In one of the many cases, Wilson v Johns-Manville Sales Corporation,[27] the District Court dismissed an action by an employee s widow on the grounds that the limitation period had expired.[28] Despite this, the Federal Court of Appeals reversed the decision and allowed to lawsuit to proceed. This decision could be viewed as harsh. Wilson started work for Manville in 1941 and by 1973 knew that he had a mild case of asbestosis. Yet he made no claim. It was only in February 1978 that he discovered that he had mesothelioma, a rare cancer caused by asbestos exposure. In May 1978, Henry Wilson died. One could ask the question how might Manville s management do business in a rational manner when, more than forty years after the situation arises, the legal rules governing that situation are abruptly altered.[29]

Examining the effects of externalities in an economic context will demonstrate how they are in fact economically inefficient. However, in order to do this, we need to first define what we actually mean by efficient. This is something that many commentators fail to do. Instead they simply assume that if it increases profits then it must be efficient. However, as we are dealing with social welfare, not just corporate welfare, profits are not a sufficient indicator.

In assessing whether or not a proposed change will increase social welfare, two measures of efficiency can be used. The first is Pareto efficiency, named after its originator Vilfredo Pareto, a 19th century Italian economist. A transaction is Pareto efficient if the change will make somebody better off without making anyone else worse off. Pareto efficient acts must increase social welfare because some people are better off whilst no one loses.

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[26] It is through this process of judicial interpretation and redefinition of the law that a company like Manville may suddenly find itself legally liable for millions of dollars in damages for activities that were not, at the time they occurred, in violation of any legal standards then existing. D. Silverstein, *Managing Corporate Social Responsibility in a Changing Legal Environment* (1987-88) 25 American Business LJ. 524 at 533.

[27] 684 F.2d 111 (D.C. Cir. 1982).

[28] The so-called discovery rule under which a cause of action accrues when the plaintiff knows or through the exercise of due diligence should have known of the injury. *Ibid.* at pp.115-6.

[29] D. Silverstein, *Managing Corporate Social Responsibility in a Changing Legal Environment* (1987-88) 25 American Business LJ. 524 at 529.

However, Pareto efficiency is rarely used to gauge social welfare because few transactions meet the criteria of producing no losers. When corporations change policy or enter into transactions, a large number of people can be affected and some are bound to be disadvantaged. It is obvious that externalities are not Pareto efficient as they involve placing costs on parties outside the corporation. These parties become worse off and so Pareto efficiency is not achieved.

Given the limitations of the Pareto standard, economists tend to adopt a more lenient benchmark. This is Kaldor-Hicks efficiency, a standard developed by two British twentieth century economists, Prof. Nicholas Kaldor and John R. Hicks.[30] Under the Kaldor-Hicks test, a change is efficient if, in aggregate, the benefits of the change exceed the costs. In such a situation, those who gain will obtain enough to compensate those who lose, although no compensation need take place. The fact that Kaldor-Hicks efficiency allows for losers means that it is less attractive from an ethical perspective than Pareto efficiency.[31] Nevertheless, Kaldor-Hicks efficiency should increase social welfare and since the Pareto test is almost impossible to satisfy, the Kaldor-Hicks standard is the one which economists tend to adopt most.[32]

However, determining whether externalities are Kaldor-Hicks efficient is much more difficult than determining if they are Pareto efficient. Under Pareto efficiency, all that is required is for one party to make a loss whereas under the Kaldor-Hicks test, the loss must be quantified. When we are dealing with social costs, this is extremely difficult to do.

The Legitimacy Argument.

Much of the literature concerning corporate social responsibility discusses the argument that certain functions are inherently political and should not be exercised by

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[30] See N. Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility* (1939) 49 Economic Journal 549 and J.R. Hicks, *The Valuation of the Social Income* (1940) 7 Economica 105.

[31] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.15.

[32] R.A. Posner, *Economic Analysis of Law*, 1992, 4th ed., Boston: Little, Brown & Co., p.14. Not all commentators use the Kaldor-Hicks standard though: see M.W. McDaniel, *Stockholders and Stakeholders* (1991) 21 Stetson L. Rev. 121 at 127, and N. Duxbury, *Patterns of American Jurisprudence*, 1995, Oxford: Clarendon Press, pp.390-1.

private institutions such as corporations. The job of corporations is to create wealth and the job of government is to redistribute that wealth. If corporations engage in social activity they ultimately usurp the inherently governmental function of wealth distribution or taxation. [33] In a wider sense, departing from the profit goal involves corporations balancing the various societal interests in an attempt to determine where the public interest lies.[34] If society decides that private charity is insufficient to meet the needs of the poor, to maintain art museums, and to finance research for curing diseases, it is the responsibility of government to raise the necessary money through taxation. It should not come from mangers purportedly acting on behalf of the corporation. [35]

Before examining this argument further, one reason why corporations are particularly susceptible to legitimacy arguments is due to the power that large corporations possess. There is nothing objectionable about individuals and small businesses going beyond the requirements of the law. However, due to the market power they possess, corporations can make decisions that can have significant public effects and, due to their desire to externalise, they can pass the cost of social responsibility onto outside parties.[36] Accordingly, this involves a trade-off between material and social prosperity and this is the function of democratically elected bodies, not private corporations.[37] If corporations were to usurp governmental functions in this way, it could lead to the corporation replacing the government, but lacking the government s accountability and ergo its legitimacy. One commentator has voiced the problem in the following dramatic manner:

> [The corporation s] proliferating employee welfare programs, its serpentine involvement in community, government, charitable and educational affairs, its prodigious currying of political and public favor through hundreds of peripheral preoccupations, all these well-intended but insidious contrivances are greasing the rails for our collective descent into a social order that would be as repugnant to the corporations themselves as to their critics. The danger is that all these

[33] J. Tolmie, *Corporate Social Responsibility* (1992) UNSWLJ 268 at 288.
[34] D. Engel, *An Approach to Corporate Social Responsibility* (1979) 32 Stan.L.Rev. 1 at 27. See A.A. Auberbach, *Law and Social Change in the United States* (1959) 6 UCLA. L. Rev. 516 at 516 who asks the question why should the corporate manager be the legitimate arbiter of the competing claims of stockholders, workers, consumers, the managers themselves and generations as yet unborn.
[35] *Corporate Responsibility* in T.L. Beauchamp & N.E. Bowie (eds.), *Ethical Theory and Business*, 1993, 4th ed., Englewood Cliffs, N.J.: Prentice Hall, p.50.
[36] R.A. Posner, *Economic Analysis of Law*, 1986, 3rd ed., Boston: Little Brown, pp.395-6.
[37] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1994, Oxford: Clarendon Press, p.318.

> things will turn the corporation into a twentieth-century equivalent of the medieval Church. The corporation would eventually invest itself with all-embracing duties, obligations and finally powers-ministering to the whole man and molding him and society in the image of the corporation s narrow ambitions and its essentially unsocial needs. [38]

Initially, this argument appears logical. However, over the last 30 years, a number of commentators have started to question the legitimacy argument.[39] They have argued that the distinction between public and private is becoming blurred and that today s large corporations are best described as public in character: in essence, corporations are becoming political institutions, and as such have the right to act in the interests of non-shareholder constituents.

There are five current theories which attempt to explain the legitimacy of the corporation as a political institution.[40] In the first, the power wielded by managers is legitimated by the control which shareholders as members of the public exercise via the corporate electoral system. In the second, large corporations are perceived as private governments with constituents including those upon whom their actions have an impact. In the third, the political character of the corporation is derived from its close relationship with the state. Thus legitimation derives from a growing assimilation of the corporation into the state. [41] The fourth theory derives from the managerialist school. It argues that the corporate manager should engage in leadership and interest balancing apparently guided largely by his or her own conscience, perhaps as it reflects the mores of society at large. [42] The final theory is that of organisational behaviourists who argue that large corporations never had profit maximisation as a single goal. Instead, corporate managers juggle competing demands, many of which are only remotely connected with economic considerations.

Irrespective of the above justifications, it may simply be the case that private enterprises can more efficiently allocate the provision of public goods than

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[38] T. Levitt, *The Dangers of Social Responsibility* in H.D. Marshall (ed.), *Business and Government: The Problem of Power*, 1970, Lexington; Mass.: D.C. Heath and Company, p.27.

[39] See *e.g.* P. Blumberg, *The Politicisation of the Corporation* (1971) Bus. Law. 1551; P. Blumberg, *The Public s Right to Know: Disclosure in the Major American Corporation* [1973] Bus. Law. 1025; R.B. Stevenson, *The Corporation as a Political Institution* (1979) 8 Hofstra. L. Rev. 39; A. Miller, *A Modest Proposal for Helping to Tame the Corporate Beast* (1979) 8 Hofstra. L. Rev. 63.

[40] These theories are taken from R.B. Stevenson, *The Corporation as a Political Institution* (1979) 8 Hofstra. L. Rev. 39 at 42-5.

[41] *Ibid.* at p.43.

governments can. In this case, it is surely societally beneficial to permit corporations to engage in social activities even if to do so is to displace a modicum of the government s power. As one commentator has noted:

> It is largely left to private enterprise to make the critical public policy decisions governmental policy must ensure the success of private enterprise. To fail to do so is to risk detrimental effects on the economy and thus on the citizenry whose welfare is the chief function of government to advance . Government must, to a significant degree, be acquiescent to the needs and demands of business for to do so is to do no more than provide good government. [43]

Accordingly, the theoretical validity of the legitimacy argument may have to give way to the practical benefits that corporate social action can offer. Both the aforementioned efficiency argument and the next argument to be examined, the market argument, rely on efficiency justifications. Accordingly, if it can be demonstrated that corporations can allocate the provision of public goods more efficiently than governments, then the validity of the legitimacy argument is weakened.

The Market Argument.

In a presence of scarce resources, individuals are forced to make choices in terms of what to consume and what to produce. When individuals make choices, they forego other opportunities. In other words, there is no such thing as a free lunch. [44] The cost of foregoing one opportunity in favour of another is known as the opportunity cost. In order to minimise the opportunity cost, rational actors will act so as to improve their own well being, often referred to as their utility, welfare or wealth. The aggregate effect of such actions occurs through the operation of markets. In economic terms, a market is a forum in which those offering to buy and sell products or services interact. [45]

Mainstream economics assumes a number of assumptions in relation to markets. It is assumed that buyers and sellers act rationally, are numerous, have full information about the products on offer, can contract at little cost, have sufficient financial

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[42] *Ibid.* at p.44.
[43] S.M. Beck, *Corporate Power and Public Policy* in Bernier and Lajoie, *Consumer Protection, Environmental Law and Corporate Power*, vol.50, 1985, Toronto: University of Toronto Press, p.184.
[44] On this infamous phrase, see R. Hessen, *Free Lunch* in J. Eatwell *et al* (eds.), *The World of Economics*, 1991, New York: W.W. Norton, p.285.

resources to transact, can enter and leave the market with little difficulty, and will carry out the obligations which they agree to perform. [46] Under these assumptions, market participants will trade until no further gains can be realised *i.e.* the equilibrium price will reflect the value placed upon the good. The distribution will be allocatively efficient. When viewed like this, voluntary exchanges through markets appear optimally efficient.

Applying this to the issue of companies, in matters of social policy companies should defer to the cumulative effect of individual preferences expressed through the market. [47] Adam Smith referred to this as the invisible hand. Companies should therefore not actively pursue social goals in the absence of market signals. This is demonstrated by the classic, if extreme, example cited by Milton Friedman. He refers to an industrial chemist who leaves her job because she prefers not to provide labour to help manufacture napalm for incendiary weapons. If many, many people feel that way, the cost of hiring people to make napalm will be high, napalm will be expensive, and less of it will be used. [48] Accordingly, morality is already in the market [49] and corporations should not try to exercise any independent moral judgment.

However, as has been noted, in order to come to this conclusion, market theory does tend to assume that a number of conditions exist. If any of these conditions are not present and the market is defective, then maybe superior results could be achieved if the company corrected market shortcomings by actively pursuing social goals and departing from the profit goal. An examination of these various assumptions will demonstrate that when a market theorist invokes the iron discipline of competitive markets as a bar to corporate social responsibility of all types, he paints a picture of market structure that we are likely to dismiss as unrealistic. [50]

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[45] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.6.
[46] *Ibid.*
[47] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1994, Oxford: Clarendon Press, p.307.
[48] M. Friedman, *There s No Such Thing as a Free Lunch*, 1975, LaSalle, Illinois: Open Court, p.245.
[49] T.M. Mulligan, *The Moral Mission of Business* in T.L. Beauchamp & N.E. Bowie (eds.), *Ethical Theory and Business*, 1993, 4th ed., Englewood Cliffs, N.J.: Prentice Hall, p.70.
[50] J.L. Mashaw, *The Economic Context of Corporate Social Responsibility* in K.J. Hopt & G. Teubner (eds.), *Corporate Governance and Directors Liabilities: Legal, Economic and Sociological Analyses on Corporate Social Responsibility*, 1985, Berlin; New York: Walter de Gruyter, p.59.

One assumption is that those who are affected by the company can affect its behaviour via the product market. However, not everyone who is affected by the company s activities has access to the market. For example, householders next to an engineering plant or the as of yet unborn will be affected by the behaviour of companies but will have no market relationship with them.[51]

A further assumption, already noted, is that buyers and sellers have full information about the products on offer. This will almost certainly not be the case. Certain market participants will have access to information that others do not. Notably, the company will have superior information than its customers. To ensure that all parties are better informed, the government can demand those with informational advantages to disclose what they know. In the UK, a public company faces substantial disclosure requirements. However, these are unlikely to fully equate the informational disparity between company and customer. Such informational inferiority will lead to sub-optimal market indications.

Imagine that a market exists where all participants have access to full information. Supposing that a company s manufacturing process resulted in environmental damage. If all market participants have access to full information, then the company s customers will respond to the environmental damage by purchasing the products of a rival company that does not damage the environment. The company will, through the product market, note their customers dissatisfaction by lower profit margins. The company can then respond by making its manufacturing process more environmentally friendly. This is the crux of the market argument. Companies should only act in a socially responsible way when indicated to do so by the market.

However, this type of market signal is likely to be very rare as the customers will usually have such poor access to information that they will never discover the company s negative social activities. The following example demonstrates this.

[51] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1994, Oxford: Clarendon Press, p.321.

The Royal Dutch/Shell Group comprises over 2000 companies in more than 100 countries.[52] It is the most profitable oil company in the world. It is responsible for 5% of the world s oil and gas production (more than any other private company). These are facts that are readily available. However, what most customers will not realise is that Shell has a notorious environmental and human rights record. Most people will be aware of the Brent Spar incident. What they will not be aware of is the disastrous social impact of Shell s business in countries throughout the world.

Ignoring Shell s environmental record, it is its human rights record that demonstrates how corporations can have significant negative impacts on whole countries. Shell is by far the largest foreign oil company in Nigeria, accounting for 50% of Nigeria s oil production. Nigeria is a military dictatorship heavily dependent on oil. By the early 1990 s, oil production accounted for 90% of the country s foreign exchange receipts.[53] In 1997, Shell admitted to importing weapons and financing the military in Ogoniland. They also supplied vehicles, boats and a helicopter to transport soldiers who raided villages.[54] In 1997, Shell signed a 40-year, $2.7 billion contract to exploit the Camisea gas field in Peru. When Shell conducted preliminary exploration of the region in the mid 1980 s, the Nahua Indians were exposed to outsiders, resulting in a whooping cough and influenza epidemic that killed off over 50% of the population.[55] During the height of the Apartheid era, many corporations and governments levied international sanctions against South Africa. Shell however, broke these sanctions and continued to sell oil to the government. As South Africa had no oil reserves of its own, oil was crucial to the South African economy. Shell s business was crucial to the government. From 1989 to 1993, Shell explored for oil and gas in Burma, giving the military junta much-needed currency and an undeserved endorsement of legitimacy.[56] Finally, in 1988, the Brazilian government proposed a number of constitutional welfare reforms aimed at greatly improving employees rights. Shell joined with 16 other corporations with Brazilian interests who together contributed $2 million on advertising and lobbying against the reforms.

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52 Financial Times International Yearbooks, *Oil and Gas*, 1993, Harlow: Longman, p.227.
53 Shell Transport and Trading Company plc., *The Annual Report*, 1995, London: Shell.
54 See Corporate Watch, *Shell: 100 Years is Enough!* [Online] Available http://www.corporatewatch.org/publications/shell.htm 10th October 2000.
55 *Ibid.*
56 A. MacSwan, *Shell is Latest Oil Company to Pull Out of Burma*, 1992, Rangoon, Reuters News Service, 24th November.

The vast majority of Shell s customers will be unaware of these facts and so the market penalty for such socially irresponsible behaviour will be slight or non-existent as the market will be unaware of it. Accordingly, Shell will get no signal from the market to curtail such irresponsible behaviour.

Even if such informational deficiencies could be cured, there are problems of collective action. If the quality of a good is poor, consumers have an incentive not to buy it. There is much less incentive, however, for customers to alter their market behaviour where the quality of the good is high, but its manufacture entails social or environmental costs. How many of Shell s customers would boycott Shell s products if they knew of the above facts? Further, since individuals know that their purchasing decisions will have a minimal impact, it will not be worth their while to incur the additional expense of changing brands unless others are willing to do so.[57]

The Stakeholders Money Argument.[58]

The *shareholders money* argument was the crux of Friedman s argument. He argued that the shareholders were owners of the corporation and so the profits belonged to them. Further, the managers as agents of the shareholders had a moral obligation to manage the company in their interests.[59] Whether the shareholders are viewed as owners, residual claimants, principals or parties to a nexus of contracts, the point is that managerial behaviour that departs from the profit goal involves a non-consensual transfer of wealth from the shareholders that is morally improper.[60]

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[57] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1994, Oxford: Clarendon Press, p.321.

[58] This argument is usually referred to as the shareholders money argument. However, as we shall see it can be argued that social expenditure spends money that not only belongs to shareholders but other stakeholders too.

[59] M. Friedman, *The Social Responsibility of Business is to Increase its Profits* in T.L. Beauchamp & N.E. Bowie (eds.), *Ethical Theory and Business*, 1993, 4th ed., Englewood Cliffs, N.J.: Prentice Hall, p.56.

[60] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1994, Oxford: Clarendon Press, p.309; D.R. Fischel, *The Corporate Governance Movement* (1982) 35 Vand.L.Rev. 1259 at 1273.

Traditionally, this argument is referred to as the shareholders money argument. However, this may be limiting the scope of the argument. As Friedman himself noted, when a director departs from the profit goal:

> [he] would be spending someone else s money for a general social interest. Insofar as his actions in accord with his social responsibility reduce return to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customer s money. Insofar as his actions lower the wages of some employees, he is spending their money. [61]

Accordingly, departures from the profit goal result in a net wealth loss, not just to the shareholders, but also to other societal groups. Therefore, and this can be linked to the efficiency argument, when management does not maximise profits, they are spending society s money. Accordingly, societal net wealth suffers.

The question that now occupies us is how valid is this argument. Focusing on the shareholders, Easterbrook and Fischel, two advocates of the Friedman school that societal well being is best-served by a policy of profit maximisation, argue that the validity of the social expenditure which departs from the profit goal depends on the method in which the investors money was solicited. They note:

> If the venture at its formation is designed in the ordinary fashion - employees and debt investors holding rights to fixed payoffs and equity investors holding a residual claim to profits, which the other participants promise to maximise - that is a binding promise. [62]

In such a situation, Easterbrook and Fischel argue that the shareholders will have a legitimate complaint if managers depart from the profit goal. However, it could be argued that this is not because the shareholders own the money that is being invested. The complaint the shareholders have is a complaint for breach of contract, not for derogation from some ethereal ideal of corporate governance. [63] Conversely, if the investment is solicited upon the pronouncement that profit maximisation is to be coupled with social expenditure, then investors who buy shares in such a company would have implicitly consented to such social expenditure. Again, it is not a matter of who owns the money; it is a contractual arrangement. For example, [i]f a corporation is started with a promise to pay half of the profits to the employees rather

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[61] M. Friedman, *The Social Responsibility of Business is to Increase its Profits* in T.L. Beauchamp & N.E. Bowie (eds.), *Ethical Theory and Business*, 1993, 4th ed., Englewood Cliffs, N.J.: Prentice Hall, p.57.
[62] F.H. Easterbrook & D.R. Fischel, *The Corporate Contract* (1989) 89 Colum.L.Rev. 1416 at 1446.

than the equity investors, that too is simply a term of the contract. [64] Determining how the company solicited the shareholders investment could be derived from the company s objects clause as this sets out the aims and business scope of the company.

The contentions of Easterbrook and Fischel are based more on the nexus of contracts conceptualisation of the firm rather than an ownership model of the firm. Accordingly, they add little to the stakeholders money argument.

The stakeholders money argument is ultimately based on issues of ownership. This has already been examined generally in a previous chapter[65] so a comprehensive analysis here will be unnecessary.

This argument can be dismissed relatively easy. Legally, from the date of incorporation, the company acquires separate personality. The company as a juristic person cannot be owned.[66] Similarly, the assets of the company belong to the corporate entity, they do not belong to the shareholders or any other group. The shareholders have no interest in the assets of the company once it is incorporated.[67] Accordingly, establishing on what purposes the company may expend assets and in whose interests it should be run on issues of ownership is not going to be successful.

Conclusion.

We have seen that the traditional arguments advocating profit maximisation are no longer enough to justify a narrow profit orientated view. This may explain why, despite recent reports stating the importance of profit maximisation,[68] a number of academics believe that corporations no longer act exclusively in the interests of profit. Writing as far back as 1970, one pro-Friedman commentator has stated that [t]he fact

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[63] *Ibid.*
[64] *Ibid.*
[65] *Supra.* at Ch. 2.
[66] Shareholders are not, in the eye of the law, part owners of the undertaking. The undertaking is something different from the totality of the shareholdings. *Per* Evershed LJ in _Short v Treasury Commissioners_ [1948] 1 KB. 116 at 122.
[67] [T]he corporator even if he holds all the shares is not the corporation, and that neither he nor any creditor of the company has any property legal or equitable in the assets of the corporation. *Per* Lord Wrenbury in _Macaura v Northern Assurance Co.Ltd._ [1925] AC 619 at 633.
[68] See *e.g. The Report of the Committee on Corporate Governance*, 1998, London: Gee Publishing Ltd., para. 1.16.

is, the profit motive is simply not fashionable today . It has been dying a lingering, unmourned death for ten years. Rarely can a big business leader eulogize it today without being snubbed by his self-consciously frowning peers. [69]

Accordingly, many argue that the profit goal is too narrow and can often ignore many contributions that the corporation actually makes. Profit maximisation requires an attention to the bottom line. [70] Accordingly, intangible contributions are left out of the equation because of their unquantifiable nature. Similarly, the bottom line will not reveal the intangible harm that the corporation may be causing. For example, under the banner of profit maximisation, corporations have polluted the environment, produced unsafe products and engaged in illegal activity. A strict adherence to profit maximisation not only provides no disincentives for this kind of behaviour, it might actually encourage it.

II. THE JUSTIFICATIONS FOR EXCLUSIVE SHAREHOLDER GOVERNANCE PROTECTION.

Adherence to the legal model of the company does not simply require that companies act in the interests of shareholders. It also requires that our company law be pro-shareholder. In the absence of such laws, those who manage companies may be tempted to depart from the profit goal. Accordingly, for the legal model to thrive, not only must companies act in the interests of shareholders, the law must protect shareholders and give them powers to ensure that the profit goal is maintained.

For reasons that will be examined, the standard analysis of the corporation found in law and economics literature assumes that shareholders should be the sole beneficiaries of corporate governance protection. This protection comes in a number of forms, but most commentators tend to focus on the existence of the fiduciary duties which, although strictly are owed to the company[71] tend to operate solely in the

[69] T. Levitt, *The Dangers of Social Responsibility* in H.D. Marshall (ed.), *Business and Government: The Problem of Power*, 1970, Lexington; Mass.: D.C. Heath and Company, p.24.
[70] L.L. Dallas, *Working Toward a New Paradigm* in L.E. Mitchell (ed.), *Progressive Corporate Law*, 1995, Oxford: Westview Press, p.45.
[71] *Percival v Wright* [1902] 2 Ch. 421.

interests of shareholders.[72] However, as we have saw in the previous chapter, there are numerous forms of protective mechanism and we also saw that almost all of them operate exclusively in the interests of the shareholders. Here, the reasons for exclusive shareholder governance protection will be examined. It will be seen that the these reasons are unacceptable in justifying exclusive shareholder governance protection. This examination when combined with an examination of these justifications in relation to non-shareholder constituents[73] and the environment[74] will demonstrate that a pluralist governance structure is more theoretically justifiable as well as more efficient.

The Shareholders as Owners.

As has already been noted,[75] historically, the notion of ownership was the principal explanation and justification for the central role of shareholders. As this theory has been examined in detail, and subsequently doubted, in this thesis elsewhere, no further examination is required here save to note that we will be examining this justification in relation to non-shareholder constituents in a later chapter.[76]

The Shareholders as Residual Risk-Bearers.

Accordingly, the justification for the pre-eminence of shareholder interests cannot be justified by relation to their ownership rights. We therefore need to look elsewhere and the modern justification frequently advanced relates to the shareholders position as residual risk-bearers. This has already been examined in a general sense as part of the efficiency justification for the nexus of contracts conceptualisation of the corporation.[77] Here, we will examine it specifically in relation to the interests of shareholders.

A brief reprisal of this theory will be of aid. As corporate performance cannot be predicted with certainty, the benefits that parties within the corporate nexus receive also cannot be predicted with certainty. However, the fortunes of one party, namely

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[72] Although as we have noted, directors can owe their duties to creditors and employees, albeit in a most unsatisfactory manner.
[73] See *infra*. at Ch. 7.
[74] See *infra*. at Ch. 9.
[75] See *supra*. at Ch. 2.
[76] See *infra*. at Ch. 7.

the shareholders, fluctuate with performance to a greater degree than other parties as other parties (*e.g.* employees, creditors) are wealth constrained and so contract for a fixed amount. As shareholders bear the risk of poor corporate performance, they should hold the rights to the firm s residual income and retain exclusive governance protection. For this reason, historically, the shareholders have been designated the party best able to bear the risk of poor corporate performance.

A simple example can be used to illustrate this point that it is economically beneficial to exclusively protect the shareholders because of the uncertain nature of their claim.[78] Suppose that a firm has two classes of claimants, fixed (such as employees and creditors) and residual (the shareholders.) At the end of period one, the firm will owe the fixed claimants £1 million. Suppose also that the firm has to choose between two prospective projects, A and B, both of which will require the firm to allocate 100% of its resources to the project. Project A has a 50% chance of producing a payoff of £1 million and a 50% chance of producing a payoff of £5 million at the end of period one. Accordingly, the expected present value of Project A is £3 million.[79] Project B has a 50% chance of a payoff of £1 million and a 50% chance of a payoff of £6 million. Thus while Project A has an expected value of £3 million, Project B has an expected value of £3.5 million.

The shareholders will obviously prefer Project B since they are better off by £500,000 if they select that project. Conversely, the fixed claimants will be indifferent because under either outcome, they will be certain to obtain the £1 million that is owed to them. Clearly, in such a situation, the fixed claimants should not have a role in the decisionmaking process. Both the firm and society are better off if the firm selects Project B because that is the project that maximises the firm s and society s wealth.

This example backs up the residual risk argument s contention that corporate governance protection should flow exclusively to the firm s shareholders. As the above decision is infra-marginal with respect to all constituencies except the

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[77] See *supra*. at Ch. 3.
[78] This example is derived from J.R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties* (1991-2) 21 Stetson LR. 23 at 28-30.
[79] (0.5 *x* £1,000,000) + (0.5 *x* £5,000,000) = £3,000,000.

shareholders, the shareholders should be the only party with legal right to the decisionmaking process. Further, the shareholder s position is unique as they are the only group with a meaningful stake in every decision made by a solvent firm.[80]

However, imagine that there was a third choice, Project C. Project C has a 50% chance of producing a payoff of £500,000 and a 50% chance of producing a payoff of $10 million. The shareholders would Project C to Projects A or B since Project C has an expected value of £5.25 million, yielding a return to the shareholders of £4.25 million. This is compared to Project A s return of £2 million (after subtracting fixed claims) and Project B s return of £2.5 million (after fixed claims.) However, unlike Project A and B, the fixed claimants are not indifferent to the choice of project as, under Project C, there is a 50% chance that they will be paid only half the £1 million that is owed to them.

Accordingly, fixed claimants will be willing to pay for the right to block Project C. Given this, it is incorrect to say that the shareholders are the only group with the correct incentives to decide between which project to adopt. Accordingly, decisionmaking powers and corporate governance protection should not flow exclusively to shareholders as other groups have an interest in corporate policy.

The notion that non-shareholder constituents contract for a fixed amount only provides a partial account as to why the shareholders have been designated the party best able to bear risk. The principal reason behind the shareholders position as primary risk-bearers is due to the fact that they can substantially reduce their overall risk via a policy of diversification. Companies do not prosper and suffer to the same extent. By holding a portfolio of shares from a large number of companies, overall risk is reduced as variations in return will offset one another. This is part of a larger theory used by financial economists to construct portfolios known as the Capital Asset Pricing Model (CAPM).[81] According to the CAPM, a numerical value (beta) denotes the variability of a return, with a higher beta representing a higher risk. Accordingly a risk-free asset (*e.g.* government bonds) is accorded a beta value of zero, whereas all

[80] F.H. Easterbrook and D.R. Fischel, *Voting in Corporate Law* (1983) 26 J.L. & Econ. 395 at 404.

the shares in the market (the market portfolio) are accorded a beta value of one. Risk is related to return. The greater the risk, the greater the possible returns. Therefore, abnormal profits are only available in the short-term. Over the long-term, returns will even out. Therefore, under the CAPM, the investor can never beat the market but nor will the market beat them.

This is an important point because it demonstrates that via a policy of diversification, share ownership may not be a particularly risky investment.[82] The residual risk argument is based on the shareholders being the party designated to bear the risk due to fluctuations in corporate performance, but as the CAPM demonstrates, the shareholders can minimise their risk to a large degree. Shareholders may be the party best able to bear risk but if the risk they face can be considerably reduced, then surely their claim to excusive governance protection is weakened. Surely, it would be more justifiable to assign governance rights according to which parties within the corporate nexus bear the most risk due to fluctuations in corporate performance.[83]

A variation of this argument argues that as shareholders bear the risk of corporate performance, they retain the ultimate authority to control the corporation because they have the greatest stake in the outcome of corporate decision-making.[84] Accordingly, fiduciary duties should be owed to shareholders as they will value fiduciary duties most highly. As they value fiduciary duties most highly, they will pay other constituencies for the right to have these duties operated in their benefit. The following example demonstrates this:

> If the shareholders place an aggregate value of $10 million on the legal protection provided by a corporate governance system that allocates fiduciary duties exclusively to shareholders, while other constituents value it at $2 million, then both parties will be better off if the shareholders are permitted to compensate these other constituencies — in the form of higher interest on bonds,

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[81] See K.P. Ambachstsheer and J.H. Ambrose, *Basic Financial Concepts: Return and Risk* in J.M. Maginn and D.L. Tuttle (eds.), *Managing Investment Portfolios: A Dynamic Process*, 1983, Charlottesville, VA: Institute of Chartered Financial Analysts, p.25 at pp.48-55.
[82] As F.H. Easterbrook & D.R. Fischel, *The Economic Structure of Corporate Law*, 1991, Cambridge, MA: Harvard University Press, p.29 state [i]nvestors who dislike risk can get rid of it.
[83] L. Roach, *The Paradox of the Traditional Justifications for Exclusive Shareholder Governance Protection: Expanding the Pluralist Approach* (2001) 22 Co.Law. 9 at 10.
[84] J.R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes* (1989) Duke LJ. 173 at 175.

> higher wages to workers and managers, and better prices for suppliers and customers — for the right to have fiduciary duties flow exclusively to them.[85]

The question remains why would shareholders place the highest value on being the sole beneficiaries of fiduciary duties. The rationale commonly given is one already mentioned, namely:

> Uniquely, the residual claimants are interested in the firm s overall profitability, whereas creditors and managers [and presumably, other constituencies as well] are essentially fixed claimants who wish only to see their claims repaid and who will logically tend to resist risky activities. Having less interest in the overall [economic] performance of the firm, creditors can bargain through contract and do not need representation on the board to monitor all aspects of the firm s performance. [86]

Accordingly, fiduciary duties run solely to shareholders because, as residual claimants, [t]he gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line. [87]

However, whilst the residual claimant argument provides a persuasive rationale for why shareholders should be beneficiaries of governance protection, it does not provide acceptable grounds for the contention that they should be the sole beneficiaries. We have already seen that fixed claimants, such as employees and creditors, can be affected by management s decisions. In later chapters, the risks that employees, creditors and the environment face will be examined in more detail.[88]

The Inadequacies of Contract.

We have already briefly noted the limited contractual protection offered to shareholders. Here, this protection will be examined in more detail. Ever since Parliament enacted the first Companies Act in the mid-19th century, English companies legislation has continued to include a provision declaring that a company s memorandum and articles constitute a contract which binds the members.[89] This provision is now contained in s.14 Companies Act 1985 which states that:

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[85] J.R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties* (1991-2) 21 Stetson LR. 23 at 26-7.
[86] J. Choper, J. Coffee & R. Morris, *Cases and Materials on Corporations*, 1989, 3rd ed., p.29.
[87] F.H. Easterbrook & D.R. Fischel, *Voting in Corporate Law* (1983) 26 J.L. & Econ. 395 at 403.
[88] See *infra*. at Chs. 7 and 9.
[89] On the history, see J.H. Farrar *et al*, *Farrar s Company Law*, 1998, 4th ed., London: Butterworths, pp.116-9; D.W. Chantler, *The Shareholders Corporate Contract in Western Australia* (1976) 12 Western Aust. L. Rev. 336 at 338-9.

> Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members

The contractual nature of the articles has been affirmed judicially on numerous occasions.[90] It is also generally accepted by the academic community.[91] This means that certain provisions in the articles can be enforced by a member in a contract action.[92] Accordingly, the articles of association offer the shareholders contractual protection. This contract can be drafted to meet the needs of the company in question and can be altered by the members via a special resolution.[93] Accordingly, as the articles represent a possible source of shareholder redress, one would assume that the shareholders would bargain with the company so as to obtain as many article safeguards as possible. However, as seen, this is not the case. Shareholders are so numerous that bargaining between shareholders and management becomes impossible.[94] Management unilaterally selects article provisions and the shareholders simply decide whether to invest or not. Investors who buy shares in the market a fortiori buy a package of rights, the contents of which are non-negotiable. [95]

Conversely, according to this argument, non-shareholder constituents (*e.g.* employees, creditors) can better protect themselves contractually by negotiating with the firm before entering into any obligations.[96] Proponents of this view therefore argue that, as shareholders cannot protect themselves contractually to the same extent as other stakeholders, the benefits of fiduciary duties should flow to them. The fiduciary duty fills the gaps in a corporate shareholder agreement. [97]

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[90] See Re Saul D. Harrison & Sons plc. [1994] BCC 475 at 488, *per* Hoffman LJ and Hickman v Kent or Romney Marsh Sheepbreeders Association [1915] 1 Ch. 881 in which Ashbury J reviews the case law in detail.

[91] See *e.g.* R.R. Drury, *The Relative Nature of a Shareholder s Right to Enforce the Company Contract* (1986) 45 CLJ 219 at 219-20 *cf.* J.H. Howard, *Fiduciary Relations in Corporate Law* (1991) 19 Can. Bus. LJ 1 at 8.

[92] K.W. Wedderburn, *Shareholders Rights and the Rule in Foss v Harbottle* [1957] CLJ 194 at 209-15.

[93] S.9 Companies Act 1985.

[94] M.A. Eisenberg, *The Structure of Corporation Law* (1989) 89 Colum.L.Rev. 1461 at 1471. See also V. Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract* (1985) 85 Colum.L.Rev. 1403 at 1412 who states that [s]cattered stockholders cannot, and do not, negotiate

[95] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.183.

[96] This is not to say that non-shareholders do not face contracting problems, but the theory argues that these non-shareholder constituents can solve these problems at far less cost than those problems confronting shareholders.

Even if the shareholders could effectively negotiate, their right to bring an action for breaches of the articles is not unqualified. Jurisprudence indicates that the articles only bestow rights on a shareholder as a member and not in any other capacity. This limits the contractual protection offered by s.14 in two ways. First, a shareholder cannot bring an action in the courts if the issue in question is a matter of internal corporate procedure as opposed to conduct affecting him as a member. Second, a shareholder cannot enforce the articles in relation to matters affecting him in a capacity other than as a member. For example, in Eley v Positive Security Life Assurance Co.,[98] the articles stated that the company employed the plaintiff shareholder for life as the company s solicitor. When his employment was terminated, the court held that he could not rely on the articles to sue the company.

Of all the arguments justifying exclusive shareholder governance protection, the inadequacy of contract argument has the most merit. There is no doubt that the shareholders cannot adequately protect themselves contractually. Even if they could, it has been argued that management will constantly introduce new strategies designed to undermine whatever contractual protection the shareholders negotiate.[99] Accordingly, for this reason, they should be beneficiaries of corporate governance protection. However, as will be seen,[100] the contention that non-shareholder constituents can protect themselves more effectively via contract will be seen to be highly questionable. If non-shareholder constituents, like the shareholders, cannot protect themselves via contract, then the shareholders right to exclusive governance protection becomes untenable.

Conclusion.

In Part I, we saw that the traditional justifications for the legal model preoccupation with profit maximisation are no longer sufficient to justify that approach. However, adherence to profit maximisation is only one part of the legal model s philosophy. The other part is that company law should exclusively protect the shareholders. In

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97 R.J. Schulze, *Can this Marriage be Saved? Reconciling Progressivism with Profits in Corporate Governance Laws* (1997) 49 Stan.L.Rev. 1607 at 1613.
98 (1876) 1 Ex. D. 88.
99 J.R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties* (1991-2) 21 Stetson LR. 23 at 39.
100 See *infra*. at Ch. 7.

this Part, we examined the three reasons for exclusive shareholder protection. Like the reasons examined in Part I, the justifications offered by the legal model are no longer sufficient to justify exclusive shareholder protection. We established in Chapter 2 that shareholders do not own the company. We also saw that whilst shareholders do bear risk in relation fluctuations in corporate performance, there are means available to them to mitigate that risk. The idea that shareholders cannot protect contractually themselves is certainly true. However, the validity of this justification in relation to the legal model is only valid if non-shareholders are able to protect themselves contractually. As we shall see in the next chapter, this is probably not the case.

CONCLUSION.

We have noted that the legal model of the company is evidenced in practice in two ways. Firstly, under the legal model, the directors should act in a manner that maximises shareholder value. Secondly, corporate governance protection should be exclusive to the shareholders.

The purpose of this chapter has been to examine the theoretical basis behind the legal model in relation to the above. In Part I, we saw that the traditional arguments for the adoption of a policy of profit maximisation are no longer persuasive. There are strong indicators that traditional tools of shareholder wealth maximisation are not profit maximising in the long run. The invisible hand of the market has been shown to be ineffective in communicating the desires of consumers and other stakeholders. The legitimacy argument is weakened given that it appears that corporations can allocate public goods more efficiently than governments can. Finally, the stakeholders (or shareholders as Freidman stated) money argument fails for the same reason that may ownership arguments fail — the assets belong to the corporate entity.

It is therefore apparent that the traditional reasons for profit maximisation are no longer strong enough to justify strict adherence to that policy.

In Part II, we examined the second tenet of the legal model, namely that corporate governance mechanisms should exclusively protect the shareholders. We saw that the traditional reasons for exclusive shareholder governance protection are so longer sufficient to justify an approach consistent with the legal model. In fact, as we shall see, in the next chapter, these traditional reasons can actually be used to justify governance protection for non-shareholder constituents.

7

Marrying the Theoretical Basis of the Legal Model and the Pluralist Approach

INTRODUCTION.

We saw in the previous chapter that the legal model s conception of exclusive shareholder protection was based upon three arguments. First, it is argued that the shareholders are owners of the company. In Chapter 2, we saw that this contention is no longer accurate. Shareholders may be owners of their shares, but shares confer no proprietary interest in the company. Here, we will demonstrate that whilst non-shareholders also have no ownership claim, their claim is no weaker than that of the shareholders. The final two arguments are derived from the new economic theory of the firm examined in Chapter 3. The second argument argues that shareholders deserve exclusive governance protection because they are the sole residual risk bearers of fluctuations in corporate performance. As we saw briefly in the previous chapter, fixed claimants can also bear residual risk. Here, the idea that non-shareholder constituents bear residual risk will be examined in more detail. Thirdly, it is contended that shareholders deserve exclusive protection because they cannot protect themselves contractually. We saw in the previous chapter that this is certainly true. However, the new economic theory argues that non-shareholder constituents, such as employees and creditors, can protect themselves contractually and therefore do not deserve governance protection. It will be seen in this chapter that this contention is highly debatable, especially in relation to employees.

The new economic theory concentrates on the relationship between the managers and the shareholders. However, by removing the shareholder s status as owner, the new economic theory removes the legal model s base for shareholder supremacy. Accordingly, there is scope to examine the contractual and risk-bearing position of non-shareholder constituents. It becomes clear that the three reasons for exclusive shareholder governance protection are no longer sufficient to justify an adherence to the legal model. In fact, it will be seen that there is a paradox in that they can be used to justify expanding governance protection to non-shareholder constituents.

Here the position of the two main non-shareholder constituents will be examined, namely the employees and creditors.[1] By using the traditional argument examined in Chapter 6, a plausible case will be put forward for the contention that not only is governance protection justified for such non-shareholder constituents, but that such expansion of company law protection can actually result in efficiency gains.

I. EMPLOYEES.

The legal model and its underlying theoretical justifications argue that shareholders occupy a precarious position within the corporation for two reasons. First, shareholders bear the most risk from fluctuations in corporate performance, and second, non-shareholder constituents can adequately protect themselves via various means, whereas the shareholders cannot. This part of the chapter contends that both of these contentions are incorrect. It will be seen that employees also bear run the risk of loss through fluctuations in corporate performance. It will also be seen that the employee s ability to protect themselves is almost as limited as that of the shareholders.

Indeed, the last 10 years have borne out the precarious position of employees, especially in relation to job losses. Over the last century, employment cycles have risen and fallen due to various economic trends. However, there is little doubt that the mass redundancies in the late 1980 s and early 1990 s were the result of corporate downsizing. The figures are considerable. Between 1987 and 1995, IBM cut over 200,000 jobs, and General Electric, even though it remained profitable, cut over 100,000 jobs during the 1980 s.[2] On 25th February 1992, General Motors announced that it was laying off 74,000 staff — making its total number of job cuts 350,000 since the early 1980 s.[3]

Many academics studying downsizing attribute the layoffs to corporations elevating profit maximisation above all other interests *i.e.* obeying the legal model s dictates of

[1] The position of the environment will be examined in Chapter 9. It is acknowledged that other constituents such as consumers and suppliers may also be worthy of protection.
[2] See *Making Companies Efficient: The Year Downsizing Grew Up* (1996) *Economist* 21st December, p.97.
[3] J.W. Singer, *Jobs and Justice: Rethinking the Stakeholder Debate* (1993) 43 Univ. Toronto LJ. 475 at 475.

corporate goals.[4] These commentators started to seriously question the narrow focus of the legal model and that governance structures should start to more effectively protect non-shareholder constituents. These layoffs also demonstrated that the employee protection envisaged by the traditional theories was not practicable. For example, two months after the General Motors layoffs, the United Auto Workers, one of the strongest unions in the United States, called off its strike of the Caterpillar company after management threatened to replace all the workers.[5] Negotiations continued but it was clear that the employees had no bargaining power.

The inability of employees to protect themselves gave stakeholder activists even more credibility. Partly due to the mass layoffs and the subsequent public outcry, many US states passed stakeholder statutes, which allowed boards of directors top depart from the legal model s narrow conceptualisation and act in the interests of non-shareholder constituents. A number of more enlightened corporations have recognised that it is in the company s long-term interests to have regard to the well being of employees. For example, in 1991, Ben & Jerry s had to temporarily close down one of its plants. Instead of temporarily laying of the employees (as would be the case under the legal model), the company continued to employ them, paying them to work at odd jobs and in community service programs.[6]

However, if employee s interests are to be fully protected, then a more convincing justification for their protection needs to be forthcoming. Here, using the traditional arguments advocated by legal model proponents, it will be demonstrated that there is a coherent, economic rationale for expanding the narrow goals of the legal model and offering legal protection to employees. Finally, we will use an economic tool termed game theory to demonstrate that employee protection can result in efficiency gains and that there is a plausible case for introducing regulation to force employers and employees to take the positions of each other into account.

[4] See *e.g.* Symposium, *The Corporate Stakeholder Debate: The Classical Theory and its Critics* (1993) 43 Univ. Toronto LJ. 297; Symposium, *New Directions in Corporate Law* (1993) 50 Washington & Lee L. Rev. 1373.
[5] K.C. Crowe, *Strikes are a Dud in Union Arsenal* (1992) *Newsday* 3rd May, p.78.
[6] See Ben & Jerry s Homemade Inc., *1991 Annual Report*, 1992, p.12.

The Employees as Owners.

It will be remembered that in Chapter 2, when defining what constituted ownership, we used Honor s definition. We saw that Honor s definition rested upon 11 characteristics. If it could be shown that the majority of these characteristics were present, the relationship could be described as one of ownership. By using Honor s test, we were able to establish that shareholders do not own the company — of the 11 characteristics, the shareholders only satisfied two.

The employees also do not own the company. However, they satisfy more of Honor s tests than the shareholders (it will be remembered that in Chapter 2 we saw that the shareholders satisfied two of Honor s tests — the employees satisfy three.) First, whereas shareholders only have a right to a dividend, the employees do have a right to an income from sale of the firm s products. Second, the employee s right to the capital value of the firm is likely to be stronger. As we saw, shareholders are only entitled to the capital value in the event of a liquidation and even then are likely to get nothing if the liquidation is insolvent. Conversely, the employees, if owed remuneration, will be classified as preferential creditors and so will stand a much stronger chance of receiving what is owed to them. Finally, although it is possible for rank-and-file employees to have a fixed term, standard practice is that, unless some form of probationary period is involved, there will be no specified duration.[7] A comparison with the position of the shareholders is set out below:

Table 7.1: Employee s Rights of Ownership.

Right	Shareholder over company	Employee over company
Possession	No	No
Use	No	No
Management	Some	No
Income	Some	Yes
Capital	Some	Yes
Security	No	No
Transmission	No	No
No limit of term	Yes	Yes
Duty not to do harm	No	No
Judgment liability	No	No
Residual control	Yes	No

[7] P. Davies and M. Freedland, *Labour Legislation and Public Policy*, 1993, Oxford: Clarendon Press, p.24.

The point that is worth noting is that, according to Honor s test, the employee s have an ownership claim stronger than that of the shareholders. Of course, both are insufficient to establish ownership, but this has not stopped the notion of shareholder ownership from remaining pervasive. If, despite all the evidence to the contrary, commentators are willing to accept that shareholders own the firm, then by the same logic, they must acknowledge that the employees also have an ownership claim.

Many commentators who advocate shareholder ownership of the firm do so, not on the basis of Honor s test, but on the basis of what the shareholders contribute, namely capital. They argue that the shareholders contribute the capital to the firm, so therefore own the firm. The flaws in this argument are obvious. First, the firm consists of more than capital — under the new economic theory, it does not even consist of that — it consists of a set of contracts. Second, whilst the shareholders may contribute the capital, it is not owned by them — it is owned by the firm, and third, not all of the capital in the firm derives from the shareholders.

It is this final criticism that merits consideration. A consistent theme of the ownership model was that as the shareholders contribute the firm s capital, they deserve to have the company run in their interests exclusively. However, the shareholders are not the sole contributors of capital. Employees contribute capital, namely human capital. Further, the form of capital that the employees contribute is unique to them, whereas the monetary capital that the shareholders contribute can be obtained from other sources, most notably creditors.[8]

The point that needs to be stressed is that whilst the company owns any asset contributed to it, it may be useful to identify the derivation of that asset. Many parties contribute capital and other assets to the firm. Given this, the real question is why is the shareholders contribution considered enough to justify their primacy under the legal model. It is contended here that it is not enough. The employees expend more time and effort contributing to the firm s well being and deserve to have this taken into account.

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[8] It is acknowledged that the forms of capital do differ with the shareholders contributing equity capital and the creditors contributing debt capital. Due to the need to adequately gear a firm, the differences between the two types of capital are important.

The Employees as Residual Risk-Bearers.

We saw in Chapter 3 that the efficiency justification for the new economic theory of the firm lay in the argument that the shareholders bear the residual risk of fluctuations in corporate performance. Conversely, non-shareholder constituents, such as employees and creditors, are wealth-constrained and so contract for a fixed amount, *ergo* they face no risk from fluctuations in corporate performance. In Chapter 6, we saw that the consequence of this was that as shareholders return is dependant on corporate performance, they should hold the right to the firm s residual income and that their interests should be exclusively protected by company law. This chapter rejects this claim that shareholders are the only bearers of residual risk. It agrees with the standard contractual contention that efficiency is maximised when governance protection is held by those who bear the residual risk. It is the identity of the residual risk-bearers that is debatable. Once the identity of the residual risk-bearers is established, and the shareholder s status as unique risk-bearers dismissed, it becomes clear that the central perceptions of the legal model also need to be reappraised.

As we have seen, the traditional argument contends that as the employees contract for fixed amounts (*i.e.* their remuneration), they bear no risk from the firm s activities. It is contended that this presumption is inaccurate due to the extent that employees subject themselves to firm-specific risk.[9] Firm-specific risk arises when stakeholders undertake investment which creates capital that is of value, or will retain most of its value, only within the context of a given firm. [10] A simple example is an employee who is trained to use a piece of machinery that is unique to one company. Here, the employee has become subject to firm-specific risk since the human capital expended to learn how to use that piece of machinery will be useless outside the firm. It may also be the case that the employee and the machine in question may become co-

[9] It is acknowledged that employees just entering the employment market will have few or no firm-specific skills. Consequently, they will be able to move easily between jobs and companies will be able to secure replacements at low cost. Their mobility will therefore be high and they will face little residual risk. On this, see P.C. Weiler, *Governing the Workplace: The Future of Labor and Employment Law*, 1990, Cambridge, Mass.: Harvard University Press, p.64.

[10] G. Kelly and J. Parkinson, *The Conceptual Foundations of the Company: A Pluralist Approach* [1998] CfiLR 175 at 184. See also J. Parkinson, *The Contractual Theory of the Company and the Protection of Non-Shareholder Interests* in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyd s of London Press, p.128 who describes it as investments in assets which cannot be redeployed to an alternative use or user without loss of productive value

specialised in that the economic rent[11] generated by the employee and the machine become dependant on the performance of the other, so that their individual contributions can no longer be identified.[12] Further, because employees who have made firm-specific investments cannot leave the company without sacrificing all or part of the value of their investment, the company s bargaining power is increased which increases the risk that the company will change the terms of the relationship to the employee s detriment. In essence, employees who have a high level of firm-specific training decrease their job mobility, *ergo* their position is riskier than a person with no firm-specific training whose job mobility will be high. Several commentators argue that employees can safeguard against this risk via contract.[13] The employees' ability to protect themselves via contract will be examined in the next section.

The important point in relation to the validity of the residual risk argument examined in the previous chapter, is that because of the potential of co-specialisation, the remuneration accrued by the employee for acquiring firm-specific skills, is no longer fixed. Instead, the employees will contribute to the total rent generated by the task, with their input being determined by a bargaining game between themselves and the company. [14] As the various factors have become co-specialised (that is the total rent is dependant upon each factor utilising their firm-specific skills), each factor has the ability to hold-up the other by threatening to withdraw from the relationship. Their ability to act on that threat will alter the total amount of rent generated by the task. The rent generated will also be affected by various external factors. The upshot of this is that the portion of the rent paid to the employees in return for acquiring firm-specific skills will be a *residual* payment, in very much the same way as the shareholders receive residual payments in the form of a dividend.[15] The return on their firm-specific investment is therefore not fixed, but, like the returns of equity

[11] An economic rent is the amount above the minimum required to attract a factor of production (such as an employee) to a particular task. Once a task has begun, any excess above the amount required to stop the factor of production from exiting the task is known as a quasi-rent.
[12] G. Kelly and J. Parkinson, *The Conceptual Foundations of the Company: A Pluralist Approach* [1998] CfiLR 175 at 185.
[13] See *e.g.* O.E. Williamson, *The Economic Institutions of Capitalism*, 1985, New York: Collier Macmillan, pp.303-4.
[14] G. Kelly and J. Parkinson, *The Conceptual Foundations of the Company: A Pluralist Approach* [1998] CfiLR 175 at 185.
[15] See P. Milgrom and J. Roberts, *Economics, Organization and Management*, 1992, London: Prentice Hall International, p.351: with high levels of firm-specific human capital, the decisions taken by the

investment, are dependent upon firm performance. Accordingly, the shareholders are not the only party to bear the residual risk of the firm s activities, and therefore, do not deserve exclusive access to the firm s residual income.

The new economic theory holds that wealth is maximised if the residual income is held by those who bear the residual risk. Now that we have seen that employees can bear residual risk, the question is will wealth-maximisation still occur. The standard response of traditional contractualists is that wealth maximisation will not occur — they argue that wealth maximisation only occurs if residual rights are vested exclusively in the hands of shareholders because the shareholders will want to maximise profits. However, there have been for many years firms that vest residual rights solely in their employees. An often-cited example is the John Lewis Partnership which operates a large chain of department stores and has annual sales of over £2 billions.[16] However, by and large, these firms do not play a major role in the UK economy and tend to operate in specialised areas.[17] In other countries however, they are more prominent. The best example is Spain s Mondragon enterprise which provides a worldwide beacon for worker self-management. [18] Mondragon is a series of worker cooperatives, which, by 1995, had over 26,000 employees and sales of nearly £5 billions.[19] It is compulsory that all employees be members of the Mondragon organization and each member is obliged to vote in electing members to the Governing Council. Neither members nor outsiders own shares in the Mondragon enterprise. Rather, a member pays an entry fee which entitles him to a capital account with the firm. The account accrues interest and receives an allocation of net profits.

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firm place risks on employees human assets that are comparable to those borne by investors physical capital.

[16] See *A Stake in the Store* (1994) *Economist* June 11th; *John Lewis Takes Partners Along on Road to Revival* (1995) *Independent on Sunday* 12th March.

[17] J. Cornford, *A Stake in the Company*, 1990, London: Institute for Public Policy Research, pp.11-13; C. Cornforth and R. Paton, *Worker Cooperatives and the Democratization of Work in Western Europe* in J.D. Wisman (ed.), *Worker Empowerment: The Struggle for Workplace Democracy*, 1991, New York: Bootstrap Press, p.59.

[18] L.D. Solomon, *On the Frontier of Capitalism: Implementation of Humanomics by Modern Publicly Held Corporations: A Critical Assessment* (1993) 50 Wash. And Lee L. Rev. 1625 at 1669. On Mondragon, see R.A.G. Monks and N. Minow, *Corporate Governance*, 1995, Oxford: Blackwell, pp.257-64.

[19] *A Change of Culture for the Basque Co-operatives* (1995) *Financial Times* 7th June.

However, as noted, firm structures such as this are in a minority in the UK. Nevertheless, it has been argued that the prominence of such firms could have a number of beneficial effects on the economy.[20]

First, it has been argued that giving employees residual rights could result in a more equitable distribution of wealth. Under the current system (*i.e.* residual rights vested solely in the shareholders), corporate profits are allocated to those who are already well off enough to afford shares.[21] Employees are more numerous than shareholders. Accordingly, if the employees had the right to the firm s residual income, the distribution of wealth amongst the nation s population would be broadened.[22]

Second, as we have seen, shareholders take a passive approach towards the companies that they invest in. Conversely, employees commit a significant portion of their time and effort towards the well being of the firm. Nevertheless, typically employees do not receive the full value created by their labour. They are paid a fixed wage with the profits being distributed to the shareholders. It can therefore be argued that the employees are not suitably rewarded for the contribution that they make. By giving employees a right to the residual income, the employees will receive the profits that they helped to generate.[23]

Third, it may be the case that firms that grant residual rights to their employees may operate in a more cost-effective manner. As noted, in a typical company, employees will not receive the full value created by their labour. They may therefore be inclined to relax on the job. They may also not be as careful with company equipment as they would their own and may even engage in self-serving conduct such as fraud or theft. Employees who have rights to the residual income will have an incentive not to partake in this behaviour. Instead of shirking, they will have an incentive to make an extra effort since this will equal extra reward. Accordingly, placing residual rights in the hands of employees should result in less absenteeism, greater work effort, better

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[20] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.557.
[21] D.P. Ellerman, *The Democratic Worker-Owned Firm: A New Model for the East and West*, 1990, Boston: Unwin, Hyman, p.53.
[22] L. Baddon *et al*, *People s Capitalism: A Critical Analysis of Profit-Sharing and Employee Share Ownership*, 1989, New York: Routledge, p.18.
[23] R.A.G. Monks and N. Minow, *Corporate Governance*, 1995, Oxford: Blackwell, pp.249-54.

maintenance of equipment and fewer instances of dishonest behaviour. [24] This will result in a lowering of costs in respect of employee monitoring.[25]

It can therefore be seen that granting employees residual rights can have a number of advantages. The question therefore is why have not more firms adopted such a structure. The simple reason is that the disadvantages of such a firm structure outweigh the advantages. It has been seen that in a market system, firms that grant employees residual rights tend to suffer in comparison with companies that grant residual rights to the shareholders. This is why such worker-controlled firms tend to operate only in specialised niches of the economy. Those who are opposed to such firms place great weight in this fact.[26] However, there are more specific criticisms.

First, in a firm that grants the residual income to its employees, each employee will receive the same salary and profits will be distributed equally. The employee will only receive a small fraction of the profits. Given this, he will have little direct incentive to maximise his performance and will not carry out his duties as efficiently as he could.

Second, it is argued that such a firm structure would jeopardize the long-term prosperity of the company.[27] It is unlikely that an employee would sacrifice their immediate well being in order to benefit the firm in the long-term. Similarly, employees are unlikely to undertake investments that could take years to produce a return. There is always the possibility that the investment will not work out as planned. Even if the investment produces a profit, the profit may not accrue until the employee has left. Accordingly, the employees will opt to maximise income now at the expense of maximising long-term cash flows.[28] Management, being aware of this,

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[24] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.558.

[25] A. Hyde, *Ownership, Contract and Politics in the Protection of Employees Against Risk* (1993) 43 UTLJ 721 at 741-2.

[26] See *e.g.* H. Hansmann, *When Does Worker Ownership Work? ESOP s, Law Firms, Codetermination and Economic Democracy* (1990) 99 Yale LJ 1749 at 1755-6; O.E. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*, 1985, New York: Free Press, pp.223-31.

[27] M.C. Jensen and W.H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination* (1979) 52 J. Bus. 469 at 485-6.

[28] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.564.

will hesitate to maintain equipment and buildings until they need to be maintained as a matter of emergency. Similarly, such firms will be unlikely to pursue research and development projects. A company that is run on such a basis will eventually be unable to compete with firms that have taken a more long-term approach.

Third, firms that grant residual rights to employees tend to find it difficult to attract investment and accordingly, tend to underinvest.[29] This places such firms at a competitive disadvantage, especially in capital intensive sectors of the economy. Even the largest worker-controlled forms face this problem. In 1995, the aforementioned Mondragon enterprise took the first tentative steps towards allowing outside investment. The management believed that the enterprise would be operating at a disadvantage if it relied solely on internally generated capital.[30]

The reason why such firms find it difficult to raise capital is because the individuals who work for such firms often do not have enough disposable income to invest.[31] Take the following example.[32] A successful employee controlled firm encounters growing demand for its products and decides to expand its productive capacity. To raise the necessary capital, the firm recruits new workers on the condition that they pay an entry fee for the right to the residual income. This would allow the company to raise the necessary capital and have the requisite staff to meet new demand. However, worker-controlled enterprises are extremely reluctant to admit new members for two reasons. First, incumbent employees will be hesitant to split the firm s profits with individuals who have not invested their time and effort into the firm.[33] Second, there exist wealth constraints. Successful businesses are worth considerable amounts of money. Accordingly, the entrance fee will be expensive. In large plywood co-operatives in America, new entrants had to pay as much as

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29 G.K. Dow, *Democracy Versus Appropriability: Can Labor-Managed Firms Flourish in a Capitalist World* in S. Bowles *et al* (eds.), *Markets and Democracy: Participation, Accountability and Efficiency*, 1993, Cambridge: Cambridge University Press, pp.176-7.

30 See *A Change of Culture for the Basque Co-operatives* (1995) *Financial Times* 7th June.

31 S. Bowles and H. Gintis, *The Democratic Firms: An Agency: Theoretic Evaluation* in S. Bowles *et al* (eds.), *Markets and Democracy: Participation, Accountability and Efficiency*, 1993, Cambridge: Cambridge University Press, pp.31-2.

32 B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.568.

33 J. Cornford, *A Stake in the Company*, 1990, London: Institute for Public Policy Research, p.21.

$100,000 (about £65,000) with a down payment of $20,000.[34] With Kiwi International Airlines, new pilots bought into the company at a price of $50,000.[35] At such levels, few employees, if any, can afford such an entrance fee.

It can therefore be seen that there are significant problems with placing residual rights in the hands of employees. Employees appear to be aware of these problems too. In companies where the employees have a sizeable equity stake, they tend to divest themselves of their shares when they get the opportunity. A good example of this concerns the National Freight Corporation plc (NFC). NFC s employees bought the company when it was privatised in 1982. In 1989, the NFC floated its shares on The Stock Exchange and at the time had 83% of shares in the hands of its employees. During this flotation, NFC s chairman stated that the test of whether employee control works is whether or not the employees sell the shares when given the opportunity.[36] If this is the case, then it failed in NFC s case. By the mid-1990s, the employees stake in NFC had fallen below 10%.

Accordingly, the contentions held by the new economic theory and the legal model in relation to the bearers of residual risk can be doubted. Shareholders are not the sole bearers of residual risk and accordingly, their right to the residual income is weakened. We have seen that due to the existence of firm-specific skills, employees can also bear residual risk. However, although this increases the employee s claim to governance protection, it does not mean the control rights should be vested in the employees as they are in the shareholders. We have seen that this can have deleterious consequences regarding the efficiency of the firm. Accordingly, the employee s position as a residual risk-bearer should be used to justify legal protection but not to give them residual control rights akin to those of the shareholders.

The Inadequacies of Contract.

We saw in Chapters 3 and 6 that the traditional legal model position is that the s.14 contract does not offer shareholders sufficient protection, whilst non-shareholder

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[34] On the entrance fee issue if plywood co-operatives, see K.V. Berman, *Worker-Owned Plywood Companies: An Economic Analysis*, 1967, Pullman, Wash.: Wash. St. Press, pp.128-9.
[35] *A Cautionary Tale of Clipped Wings* (1995) *Financial Times* 23rd June.
[36] J. Cornford, *A Stake in the Company*, 1990, London: Institute for Public Policy Research, p.21.

constituents can protect themselves contractually and so do not value governance protection as highly as the shareholders. However, there are numerous reasons to believe that employees cannot protect themselves in a way that traditional theorists think. This part of the chapter will examine the employee s ability to protect themselves contractually. It will be seen that their ability to protect themselves through explicit contract terms is extremely limited.[37] Given this, a number of commentators have argued that employees deserve protection based upon terms that are implicit or hypothetical within the employment contract. These theories will also be examined.

Explicit Contractual Protection.

As has been noted, the new economic theory holds that employees can protect themselves via explicit contractual terms in the employment contract. It will be seen that this can be doubted for two reasons. First, contractualists only focus on monetary interests and ignore more amorphous employee interests. Second, it is highly unlikely that employees can obtain any real protection through bargain. These will now be examined.

It has been contended that contractualists assess the costs of profit maximisation too narrowly. The contractual approach tends to focus on monetary considerations whilst ignoring more intangible but no less real costs. For example, if a worker was laid-off, the contractualists would focus simply on the discounted present value of the income that he or she would have earned, les any offset due to reemployment. They would not focus on psychological factors affecting the former-employee such as low self-esteem. Even if the former-employee did find alternative employment, he might suffer from insecurities in adjusting to his new working environment. Whilst these costs are almost impossible to assess in monetary terms, they are no less for that reason.[38]

[37] Although occasionally, it is possible. In America, it is now common for employment contracts to include tin parachute clauses which entitle rank-and-file employees to severance pay if they lose their jobs as the result of a takeover. See R. Howse and M.J. Trebilcock, *Protecting the Employment Bargain* (1993) 43 UTLJ 751 at 758-9.
[38] D. Millon, *Communitarians in Corporate Law: Foundations and Law Reform Strategies* in L.E. Mitchell (ed.), *Progressive Corporate Law*, 1995, Boulder, Colorado: Westview Press, p.5.

Also the scope of people affected adversely by profit maximising activities is defined very narrowly by contractualists. For example, a plant closing will involve more than employee layoffs and the termination of certain commercial relationships. Consumers may lose access to certain products and communities will lose tax revenues and charitable donations.

It will also be the case that many types of conduct harmful to employees will be difficult to foresee and therefore difficult to safeguard against contractually. This usually results from informational asymmetries benefiting management. Employees may be totally unaware of plans to close a plant and shift production to another location. Even where future contingencies are foreseeable, employees may choose not to bargain about them, believing that the remoteness of the risk does not justify the time and expense needed to decide *ex ante* how the costs are to be apportioned.

These difficulties make it significantly less likely that agreements will be reached. A further major problem relates to the respective bargaining power of the employees when compared to management. However, before we examine disparities of bargaining power, it is worth examining whether or not free bargaining can actually provide adequate employee protection.

The fundamental assumption underlying the new economic theory s reliance on non-shareholder protection through contract is that consent should be the sole basis for obligation. Contractualists argue that unless shareholders have consented to forego profit maximising activities, they should be under no obligation to sacrifice profits so as to benefit non-shareholders. If this consent is not present, the obligation on them becomes one of coercion. Coercion results in a lack of autonomy and autonomy is important because it implies an opportunity to pursue self-interest. This objective is best furthered by a legal regime dedicated to freedom of contract. And, if wealth is increased through unconstrained, then maximising freedom of contract will also maximise social wealth. [39] This was the fundamental normative premise underlying the new economic theory as we saw in Chapter 3.

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[39] *Ibid.* at p.7.

However, many commentators reject this premise. Instead, they argue that freedom of contract is insufficient to provide all parties with adequate opportunities to pursue notions of self-interest. These commentators begin by pointing out that bargaining power is linked to wealth. As under the new economic theory, the shareholders obligation is defined by reference to consent, the employee s ability to protect themselves from the costs of shareholder wealth maximisation will depend on the employee s ability to bargain and pay for the necessary protection. Assume that the employees are fully aware of the ways in which they are vulnerable and the process of bargain with management was cost-free. Even in such a situation (which in reality could never be), there would be uncircumventable limits to the protection that employees could obtain by contract. The employee s ability to obtain governance safeguards from management would depend on their ability to pay for them. Some highly valued contractual terms would simply be too expensive to pay for; others would result in unacceptable sacrifices. It may therefore be the case, that even if bargaining were possible, it would not result in an acceptable standard of protection for employees. And as we saw in Chapter 3, the new economic theory is premised upon effective bilateral protection based upon free contracting. It has been seen that contractual protection is not bilateral and contracting is certainly not free.

Given that employees, like the shareholders, cannot effectively protect themselves contractually, the law should step in to fill the gaps in the employment contract. There are already indications that this is starting to happen. For example, formerly, under case law principles, when a business was sold, this had the effect of terminating all employment contracts. Statutory measures now ensure that employment contracts in place at the time of the transfer are binding on the transferee and any dismissal is unjustified unless it is for an economic, technical or organisational reason.[40]

Implicit Contractual Protection.

Many employment contracts fail to take into account the existence of firm-specific risk. This highlights another possible reason for employee protection. It is extremely difficult to draft complete contracts that protect employees who have made firm-

[40] See Transfer of Undertakings (Protection of Employment) Regulations 1981, SI 1981/1794 (as amended by s.33 Trade Union Reform and Employment Rights Act 1993.)

specific investments. In fact, it is the case that complete contracting is impossible because certain employee interests are too uncertain to contract for *e.g.* complete contracts would need to protect the ability of the employees to accrue a return on their human capital investment *i.e.* continuity of employment.

It is therefore apparent that employees can only obtain limited contractual protection because of the uncertain nature of their interests. Nevertheless, these interests are worthy of protection. A popular thesis in recent years has been that these interests are contractually protected by what have been termed implicit employment agreements. It is already the case that the courts will imply into the employment contract certain terms *e.g.* that employees are to have a right to reasonable notice prior to dismissal.[41] Here we are concerned with implicit agreements promising something more substantial, namely job security. This idea that companies enter into implicit agreements promising continuity of employment is at odds with neo-classical assumptions, which assumes that employees are paid an amount equivalent to their marginal product.[42] According to the implicit contract thesis, at the outset of their careers, employees accept a wage that is lower than their marginal product. In return for this income sacrifice, employees are promised job security and an increase in remuneration during the later phases of their careers (when their wage is likely to be larger than their marginal product.)[43] In effect, the employees have paid an insurance premium in the early years for which they obtain a return in later years. [44] There are two reasons to adopt such a scheme. First, by deferring compensation, implicit employment agreements deter shirking and other forms of employee behaviour because junior employees become bound to their work by the threat of possible future income forfeiture should their performance be inadequate.[45] This

[41] P. Davies and M. Freedland, *Labour Legislation and Public Policy*, 1993, Oxford: Clarendon Press, p.24.
[42] K. Stone, *Labour Markets, Employment Contracts and Corporate Change* in J. McCahery, S. Piccioto and C. Scott (eds.), *Corporate Control and Accountability: Changing Structures and the Dynamics of Regulation*, 1993, Oxford: OUP, pp.70-1.
[43] M.A. O Connor, *Promoting Economic Justice in Plant Closings: Exploring the Fiduciary/Contract Law Distinction to Enforce Implicit Employment Agreements* in L.E. Mitchell (ed.), *Progressive Corporate Law*, 1995, Boulder, Colorado: Westview Press, p.219.
[44] J. Parkinson, *The Contractual Theory of the Company and the Protection of Non-Shareholder Interests* in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyd s of London Press, p.132.
[45] M.A. O Connor, *Promoting Economic Justice in Plant Closings: Exploring the Fiduciary/Contract Law Distinction to Enforce Implicit Employment Agreements* in L.E. Mitchell (ed.), *Progressive Corporate Law*, 1995, Boulder, Colorado: Westview Press, p.219.

bonding mechanism also protects the company s investment in the employee by ensuring that this investment is not wasted by the employee s early departure. Second, as employees have a promise of job security, they have an incentive to learn firm-specific skills of the kind described earlier. These skills are of no value outside the firm, but as the employees have an expectation of continued employment, these skills will remain useful throughout their careers.

One notable question is if the above guarantee of job security is so important to employees, why use implicit agreements rather than explicit contracts. The main reason is that the anticipated benefits of implicit employment agreements are not reducible to bargaining terms. The deferred compensation thesis is designed to motivate employees to increase productivity so that their future income stream is not threatened. The terms contained in explicit contracts do not induce employees to engage in increased productivity. The plain fact is that [d]etailed contractual specifications simply cannot describe this kind of worker motivation. [46]

Given that factors such as worker motivation cannot be defined in explicit contract terms, implicit agreements are used, but a significant issue must be what legal standing do these implicit agreements have. There is little doubt that they are not contracts in any legal sense because they are not the result of bargaining, nor are they implied contracts. Instead, the implicit agreement is a unilateral promise made by employers to workers, not as a result of bargaining, but because it serves their production and organizational goals. [47] Accordingly, implicit agreements are used because it benefits both parties to do so. Employees cannot contract for job security because of drafting inadequacies and, even if they could do so, the cost borne by them in the form of reduced wages would be too great. It is also in the interests of employers to honour implicit agreements in order to maintain a reputation of trustworthiness. Should an employer opportunistically breach an implicit agreement with his employees, this will send a detrimental message to all other parties that the employer has long-term relationships with. In time, this could deprive the company of such relationships; relationships that are necessary to the long-term profitability of

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[46] *Ibid.* at p.220.

the company.[48] Whilst this justification does have merit, if employers prematurely terminate employment, they, in effect, take back the deferred compensation that they owe to that employee. This results in an opportunistic transfer of wealth from the employees to the shareholders. It is believed by many that this temptation is too great for most managers,[49] especially given that the courts have on numerous occasions, allowed managers to break implicit contracts with employees. For example, some employers have breached implicit promises to provide health insurance by changing the benefits structure to exclude employees who have AIDS.[50]

Given this temptation, a plausible argument for legal enforcement of implicit agreements has arisen. Employers, by deferring compensation, have induced reliance on the part of the employees that they will have continuity of employment. Given that market pressures exist which induce management to opportunistically terminate these implicit agreements, they should be protected. However, because they are not traditional explicit or implied contracts, traditional remedies for breach of contract (*i.e.* damages) are not available. The most common form of protection is the extension of the director s fiduciary duties to the employees. Fiduciary law is broader than contract law, and so can protect legitimate expectations that will not be protected under contract law. An excellent example of this is the case of *Ypsilanti v General Motors Corp*.[51] Here, the township of Ypsilanti gave General Motors eleven tax abatements of over $1.3 billion over a 15-year period. When applying for the most recent abatement, a GM spokesman said [u]pon completion of this project and favorable market demand, it will allow Willow Run to continue production and maintain profitable employment for our employees. [52] Despite high market demand, GM announced that it was closing the Willow Run Plant and moving to another facility. The lower court utilised promissory estoppel to force GM to keep the Willow

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[47] K. Stone, *Labour Markets, Employment Contracts and Corporate Change* in J. McCahery, S. Piccioto and C. Scott (eds.), *Corporate Control and Accountability: Changing Structures and the Dynamics of Regulation*, 1993, Oxford: OUP, p.87.
[48] J.G. MacIntosh, *Designing an Efficient Fiduciary Law* (1993) 43 Univ. Toronto LJ. 425 at 470-2.
[49] M.A. O Connor, *Promoting Economic Justice in Plant Closings: Exploring the Fiduciary Contract Law Distinction to Enforce Implicit Employment Agreements* in L.E. Mitchell (ed.), *Progressive Corporate Law*, 1995, Boulder, Colorado: Westview Press, p. 220; J. Parkinson, *The Contractual Theory of the Company and the Protection of Non-Shareholder Interests* in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyd s of London Press, p.133.
[50] T.B. Stoddard, *Now You re Insured, Now You re Not* (1992) *New York Times* 23rd May.
[51] 506 NW. 2d. 556 (Mich. Ct. App. 1993).

Run plant open.[53] On appeal, this decision was reversed because the court held that the above statement was not the type that could be construed as a clear promise: it was simply an expression of GM s hopes and expectations.

There is little doubt that this decision is correct as a matter of contract law — the informal statements made by the GM spokesperson were not promissory.[54] However, this decision does seem very harsh on the people of Ypsilanti. They had agreed to tax abatements because GM had tempted them with jobs. Under the fiduciary thesis however, it would no longer be necessary to analyse this situation in terms of contractual constraints. There is little doubt that had the court applied the implicit agreement thesis in the Ypsilanti case, they would have held that GM had breached the trust and confidence that the Township placed in it and would have required that GM maintain employment at the Willow Run plant until such a time as Ypsilanti had recouped its investment.[55]

It is therefore apparent that the primary means of protecting implicit agreements is by extending the fiduciary duty. The question we must now ask is in what circumstances will the courts extend the director s fiduciary duties in this manner.

To date, the UK courts have not looked at this issue in any real detail. In America, however, the issue has received considerable judicial attention. Should the implicit agreement thesis become manifest in the UK, it is likely that the UK courts will look at the same factors. Accordingly, the following analysis primarily examines the US position.

The courts have not been consistent in their acceptance of an extension of the fiduciary duty. Some refuse to accept that implicit agreements can alter the content of the legal model stating that they are unwilling to radically alter the scheme of

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[52] *Ibid.* at p.561.
[53] *Charter Township of Ypsilanti v General Motors Corp.*, No. 92-43075-CK, slip op. (Cir. Ct. Washtenaw County, Mich., Feb. 9, 1993).
[54] M.A. O Connor, *Promoting Economic Justice in Plant Closings: Exploring the Fiduciary/Contract Law Distinction to Enforce Implicit Employment Agreements* in L.E. Mitchell (ed.), *Progressive Corporate Law*, 1995, Boulder, Colorado: Westview Press, p.228.
[55] *Ibid.* at p.230.

commercial dealings. [56] Most members of the American judiciary are, however, willing to acknowledge that the term fiduciary is a broad one, able to take into account informal and implicit arrangements.[57]

The case law to date reveals that when determining whether or not to extend the fiduciary duty, the courts will look for three characteristics: (i) whether the relationship involved a high degree of trust, (ii) whether the relationship has continued for a long period, and (iii) whether one party is vulnerable because it relies on the other s decisionmaking discretion.[58] Experience has shown that it is difficult for an implicit agreement to satisfy the test lad down by the court, but occasionally the case law demonstrates that the test can be met.

The main factor the courts emphasize in finding an extended fiduciary relationship is the degree of trust. There must be a greater degree of trust than in a traditional arm s-length relationship; so much so that it results in a moral commitment to maintain the relationship in adverse conditions.[59] The courts recognise that trust of this nature requires time to foster and therefore, will examine the length of the relationship to determine if it has existed for a sufficient period.[60] However, to date, the court s application has not been consistent, with one court finding a relationship of 24 years sufficient,[61] and another finding a relationship of 42 years insufficient.[62] In any case, the time period is a contributory factor rather than a controlling one. Absent a long-term relationship, the courts will occasionally find a sufficient relationship of trust.[63]

We have seen that according to traditional contractual theory, fiduciary duties should not flow to non-shareholders because they can protect themselves via contract. We

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[56] *Ritchie Enter v Honeywell Bull Inc.*, 730 F. Supp. 1014, 1054 (D. Kan. 1990); *Vanguard Telecommunications Inc. v Southern New England Tele. Co.*, 900 F.2d. 645, 653 (3d. Cir. 1990).
[57] D. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation* (1988) Duke LJ. 879 at 915.
[58] *Broomfield v Kosow*, 212 NE. 2d. 556, 560 (Mass. 1965).
[59] *Gorski v Gorski*, 262 N.W. 2d. 120 (Wis. 1978) (holding that such a relationship could be inferred where parties were close, personal friends for over 28 years.)
[60] See *e.g.* *Walker v U-Haul Co.*, 734 F. 2d. 1068, 1071 (5th Cir. 1984) (holding that a 14 year relationship was sufficient); *Caserotti v State Farm Ins. Co.*, 791 S.W. 2d. 561, 565 (Tex. Ct. App. 1990) (stating that [p]roof of a confidential relationship outside the formal cases requires evidence that the dealings between the parties have continued for so long that one party is justified in relying on the other to act in his best interests.)
[61] *Deist v Wachholz*, 678 P.2d. 188, 193 (Mont. 1984).
[62] *Crim Truck & Tractor Co. v Navistar Int l Transp. Corp.*, 823 S.W. 2d. 591, 593 (Tex. 1992).
[63] See *e.g.* *Harris v Sentry Title Co. Inc.*, 727 F.2d. 1368 (5th Cir. 1984).

have also seen that this contention can be doubted. However, if it can be shown that the employee in question has the ability to protect themselves in commercial dealings, then the courts will be reluctant to extend the fiduciary duty.[64] For example, in Lee v Wal-Mart Stores Inc.,[65] the court found no fiduciary duty between a property developer and Wal-Mart where the parties had informal relations developed over a ten-year period. The developer purchased land and built nine stores at Wal-Mart s direction based on oral approval from Wal-Mart s management. When Wal-Mart did not comply in the usual manner, the developer sued for breach of fiduciary duty. The court, in rejecting his claim, emphasised the developer s ability to protect himself through a written contract, adding that as an experienced businessman, he should have known that relaxed business practices of this type were risky.[66] It may also be the case that too many protective arrangements will indicate to the court that a close relationship of trust is not present. Accordingly, the courts have refused to extend the fiduciary relationship when the parties have had several meetings, used lawyers in negotiations, maintained written records and took time to consider proposals.[67]

Not all courts, however, take the view that trust is the primary factor. Some have taken the view that the length of time or the closeness of the relationship are irrelevant. What is relevant is the amount of control that one party has over the other.[68] They emphasise that one party usually occupies a vulnerable position which causes them to rely upon the other. The type of vulnerability is usually a disparity of business experience where a pattern develops whereby one party unquestioningly follows the dominant party s advice.[69]

There is little doubt that the implicit agreement thesis is one of the more plausible and sophisticated arguments in relation to the protection of non-shareholder constituents. However, it has shown itself to be problematic for numerous reasons. The most obvious criticism that can be levelled at implicit agreements is their indeterminate

[64] See *e.g.* *Flight Concepts Ltd. Partnership v Boeing Co.*, 819 F. Supp. 1535, 1546 (D. Kan. 1993); *In re Colocotronis Tanker Sec. Litig.*, 449 F. Supp. 828, 833 (SDNY 1978).
[65] 943 F. 2d. 554 (5th Cir. 1991).
[66] *Ibid.* at p.557.
[67] See *e.g.* *Ritchie Enter v Honeywell Bull Inc.*, 730 F. Supp. 1014, 1054 (D. Kan. 1990).
[68] See *e.g.* *Cara. Corp. v Continental Bank*, 148 BR. 760 (E.D. Pa. 1992).
[69] See *e.g.* *Production Credit Association v Farm Credit Bank*, 781 F. Supp. 595, 610 (D. Minn. 1991); *Minnesota Timber Producers Association v American Mutual Insurance Co.*, 766 F.2d. 1261, 1267 (8th Cir. 1985), *cert. denied*, 474 US. 1059 (1986).

nature. It was always going to be the case that implicit agreement s content is unavoidably obscure and hence contentious. [70] This uncertainty will result in differing interpretations and different outcomes.[71] Whether an employee receives compensation would depend on the idiosyncratic and subjective appraisals of whoever hears the case. [72]

Although the indeterminacy criticism is inherent in the implicit agreement argument, it has been contended that it is not dispositive for two reasons. First, the courts confront difficult appraisal issues every day — they are required to appraise the future value of shares and damages resulting from torts and breaches of contract.[73] Difficulty of quantification is not enough to totally dispose of the argument. Second, Stone argues that the promises of job security contained in implicit agreements are not imaginary or hallucinatory but are contained in the ubiquitous employer statements found in words, writings, and deeds to the effect that if you work here, if you do a reasonable job and don t cause trouble, you have a job for life. [74] Stone s contention can be criticised on various grounds. It is highly unlikely that today, such statements are ever made, let alone them being ubiquitous. Even if they are made, they are made with the knowledge that redundancies following, for example, a takeover, are common. Such statements must be read with this in mind.

A second criticism is that even if implicit promises are made, they are not made to all employees. In order to keep up with demand, and bearing in mind that the training required for many jobs will be minimal, employers will make full use of casual and part-time labour. Such employees will have no guarantee of employment.

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[70] J. Parkinson, *The Contractual Theory of the Company and the Protection of Non-Shareholder Interests* in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyd s of London Press, p.134.

[71] H. Collins, *Organisational Regulation and the Limits of Contract* in J. McCahery, S. Piccioto and C. Scott (eds.), *Corporate Control and Accountability: Changing Structures and the Dynamics of Regulation*, 1993, Oxford: OUP, p.97.

[72] D. Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies* in L.E. Mitchell (ed.), *Progressive Corporate Law*, 1995, Boulder, Colorado: Westview Press, pp.19-20.

[73] R.J. Schulze, *Can This Marriage Be Saved? Reconciling Progressivism with Profits in Corporate Governance Laws* (1997) 49 Stan.L.Rev. 1607 at 1618.

[74] K. Stone, *Labour Markets, Employment Contracts and Corporate Change* in J. McCahery, S. Piccioto and C. Scott (eds.), *Corporate Control and Accountability: Changing Structures and the Dynamics of Regulation*, 1993, Oxford: OUP, p.88.

Accordingly, as part-time employees become more common, the implicit agreement thesis will become an irrelevance to a larger proportion of the workforce.[75]

Third, even if it can be shown that implicit promises of job security are made, it is highly debatable that they are accompanied with an acknowledgement that they are legally enforceable. The implicit agreement argument actually has a sanction inherent to it, namely reputational damage. To allow legal enforcement would be to give the employees a remedy above and beyond that envisaged by the implicit agreement thesis.[76] Even firms that respect the value of secure employment need to have the ability to make redundancies if market pressures dictate. This is well illustrated by the layoffs at IBM in the late 1980s and early 1990s. For many years, IBM refrained from carrying out mass-layoffs and its executives stated that the company s practice was to ensure that the employees were content and productive.[77] However, between 1986 and 1994 the company reduced its workforce from 407,000 to 215,000.[78] IBM s managers felt compelled to make these layoffs following a sustained period of poor earnings. Further, if legal enforcement were permissible, then it could have an unforeseen consequence. If employees could persuade the court that they had a legal right regarding deferred compensation, then, by the same logic, firms might be able to bring claims against employees who want to leave their employment. Firms that expend capital training their employees could validly argue that they have a long-term property interest in the employee, with the consequence that the employee should not be allowed to leave until the firm has recouped its investment.[79]

Finally, as we shall see later, there are significant problems with a multifiduciary duty.[80] There are arguments that a multifiduciary duty can actually reduce accountability and increase the length of cases. Under the legal model, managers have only to maximise profits. If directors owed their duties to shareholders and

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[75] J. Parkinson, *The Contractual Theory of the Company and the Protection of Non-Shareholder Interests* in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyd s of London Press, p.134.
[76] R. Daniels, *Stakeholders and Takeovers: Can Contractarianism be Compassionate?* (1993) 43 Univ. Toronto LJ. 315 at 337-8.
[77] J. Bolt, *Job Security: Its Time Has Come* (1983) Harv. Bus. Rev. 115 at 116-8.
[78] *When Slimming is Not Enough* (1994) *Economist* 3rd September.
[79] R.J. Schulze, *Can This Marriage Be Saved? Reconciling Progressivism with Profits in Corporate Governance Laws* (1997) 49 Stan.L.Rev. 1607 at 1618.

employees (as would be the case if the implicit agreement thesis could result in legal obligations) then the default rule would be that directors must maximise profits and provide job security for their employees. This would complicate managerial decisionmaking greatly. A simple and oft-cited example demonstrates this. Assume that a firm is considering closing a plant and laying off a considerable number of employees based on clear evidence that this would make the firm more efficient and increase profits. Shareholder interests would demand that the plant be closed. Employee interests would dictate that the plant be kept open. This situation may be complicated by the fact that employees in the firm s other plants would want the plant closed to ensure the continued profitability of the firm and therefore their jobs. It has been argued that as the directors could never please both constituents totally, both parties would resort to the courts to micromanage corporate decisionmaking when there was a possible conflict.[81]

The implicit agreements thesis is a brave attempt to find a credible means of attacking the legal model of the company. However, as we have seen, it can be criticised on numerous grounds. It relies on contractual premises to justify greater employee protection, so therefore, it must broadly agree with the new economic theory of the firm. However, the new economic theory and the implicit agreement thesis are irreconcilable for the following reason. The new economic theory argues that fiduciary duties should flow exclusively to shareholders because other constituents can protect themselves via contract. The implicit agreements thesis argues that employees cannot protect their job security explicitly by contract because it is too indeterminate a concept. However, there is implicit protection hidden in the cracks between the explicit terms which contain no such protection. [82] Accordingly, there is contractual protection for the employees, albeit in an implicit form. The implicit agreement thesis requires that fiduciary duties be extended to employees because of the implicit contractual protection. However, the new economic theory would see these implicit agreements as proof that employees can protect their interests via contract and so would not require fiduciary duties to flow to them. Finally, many

[80] Here the term multifiduciary duty is used to describe a duty that is owed to more than one party within the corporate nexus.

[81] R.J. Schulze, *Can This Marriage Be Saved? Reconciling Progressivism with Profits in Corporate Governance Laws* (1997) 49 Stan.L.Rev. 1607 at 1619.

implicit agreement proponents ignore the fact that if employees could sue for breach of implicit agreements, then companies could simply draft explicit clauses into employment contracts disclaiming any such agreements.[83]

Transactional Failure.

Given these flaws, over the last few years, a new contractual model has arisen that, instead of concentrating on implicit agreements, serves to strengthen the employee s explicit contractual protection by focusing on various forms of transactional failure. This transactional failure argument has been advocated most strongly by Professor Ronald Daniels.[84] Professor Daniels starting point is to ask whether employers actually make the sort of promises that the implicit agreements thesis relies on. Due to inadequate employee information, the answer is usually no. Employees are unlikely to be informed about factors affecting job security, such as takeover activity. Accordingly, the bargain they make with management will be different than the one they would have made had they had full information. If employees were aware of these factors, they would contract for higher wages, or severance payments upon dismissal.[85] Thus the 1980 s takeover wave would not have been anticipated by those drafting contracts prior to 1980, and therefore some of the employees who lost their jobs would suffer an uncompensated loss in wealth.[86] Given unforeseen events such as this can and do occur, it is likely that there is no agreement regarding the management s ability to act for the benefit of the employees under future circumstances that are unforeseeable. The lack of agreement would constitute a gap in the contract, and accordingly, no implicit agreement could be founded. Even if

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[82] D. Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies* in L.E. Mitchell (ed.), *Progressive Corporate Law*, 1995, Boulder, Colorado: Westview Press, p.20.
[83] In relation to this, it has been argued that managers could eliminate the shareholder expectation of profit maximisation by writing clauses into the s.14 contract stating that managers are not expected to maximise profits. However, such disclaimers do not exist. Why might they exist in relation to employees but not in relation to shareholders? The difference can be explained by bargaining differences. Shareholders would not invest unless they believed that the management would make an effort to maximise profits — they would invest in companies committed to profit maximisation. Thus, to compete, managers must promise to maximise profits. Conversely, many employees do not have such bargaining power because firms regard their labour as dispensable — there are others waiting to take their jobs who will not care about implicit agreements.
[84] See R. Daniels, *Stakeholders and Takeovers: Can Contractarianism be Compassionate?* (1993) 43 Univ. Toronto LJ. 315.
[85] J. Parkinson, *The Contractual Theory of the Company and the Protection of Non-Shareholder Interests* in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments*, 1996, London: Lloyd s of London Press, p.137.

there is no implicit agreement, however, a hypothetical contract approach may be used to justify protection of employee interests. A court might fill the gap in the contract by attempting to determine what the parties would have done had they been apprised of the risk at the time of the [contract] formation. [87] Judicial intervention would be justified on the basis of mutual mistake due to incomplete formation.[88] Daniels believes that this hypothetical contract rationale would justify plant closure legislation, mandatory successorship rights, and mandatory bargaining [89]

The point that both of these theories emphasise is that employees cannot protect themselves by explicit contract terms. Indeed, this is starting to be recognised by contract theorists. Macey and Miller, two ardent proponents of the contractual thesis, only go so far as to say that contractual protection is only technologically feasible, not that employees are actually able to obtain such protection.[90] As we have seen, it is highly unlikely that employees do obtain such protection. Accordingly, the reform proposals mentioned try to extend protection to employees by protecting interests that would be protected in an ideal contracting regime, but are currently unprotected. The problem is that the interests that these contractual mechanisms try to protect are overly ambiguous. A move to protect such interests would constitute a radical departure from the legal model, and therefore needs to be substantial enough to justify such a move. Currently, the interests recognised by the implicit agreements thesis and the transactional failure argument are not substantial enough to warrant reform.

Ultimately, it may be the case that both of these arguments miss the point. The legal model states that as shareholders cannot effectively protect themselves via contract, and therefore fiduciary duties should flow exclusively to them to fill the gap in the s.14 contract. It further states that employees can protect themselves via contract and therefore do not need any form of legal protection. We have seen that this second contention is flawed. The employees cannot protect themselves contractually and

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[86] R. Daniels, *Stakeholders and Takeovers: Can Contractarianism be Compassionate?* (1993) 43 Univ. Toronto LJ. 315 at 345-9.
[87] *Ibid.* at p.341.
[88] D. Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies* in L.E. Mitchell (ed.), *Progressive Corporate Law*, 1995, Boulder, Colorado: Westview Press, p.18.
[89] R. Daniels, *Stakeholders and Takeovers: Can Contractarianism be Compassionate?* (1993) 43 Univ. Toronto LJ. 315 at 350.
[90] J.R. Macey and G.P.; Miller, *Corporate Stakeholders: A Contractual Perspective* (1993) 43 Univ. Toronto LJ. 401 at 416-9.

therefore, according to the logic of the legal model itself, they deserve protection. Given this, there appears to be no need to construct elaborate contractual arguments that protect ethereal employee interests. Both of the above arguments advocate employee protection based on identifiable gaps in the employee contract. The above arguments also seek to identify these gaps. However, there is no need to identify these gaps — the fact that the gaps exist justifies employee protection. According to both the legal model and the new economic theory, any group that cannot protect themselves contractually deserve protection from the law. Both the legal model and the new economic theory state that the only constituent that cannot protect themselves are the shareholders. It has been shown in the part of the chapter that this assumption is incorrect. We will see that there are also other constituents that also cannot protect themselves in a way that the legal model envisages.[91]

Why are Employees Not Better Protected?

From the above, it can be seen that there is a strong case for employee protection. However, as we saw in Chapter 4, the protection offered to the employees is scant. The question is given that protective measures for employees can result in efficiency gains, why do companies not demonstrate a greater commitment to their workforce. An efficiency-related explanation can be derived from what economists term game theory. Game theory has been described as an analytical device which allows for formal, rigorous examinations of individual decision-making, sheds light on situations where rational conduct will lead to sub-optimal outcomes. [92] By use of this theory it will be seen that although protecting employees can result in optimum efficiency, firms have an incentive not to do so.

In our game,[93] the players are the employer and the employee, both with two choices. The employer has the choice of providing a high cost or a low cost workplace. Under the high cost option, the employer regularly consults his employees and

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[91] Next we will see that creditors also have problems protecting themselves contractually, although they do appear to be in a stronger position than the employees. In Ch. 9, we will see that the environment has virtually no contractual protection at all.

[92] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.10. On game theory generally, see S.H. Heap *et al*, *The Theory of Choice: A Critical Guide*, 1992, Oxford: Blackwell and D.G. Baird *et al*, *Game Theory and the Law*, 1994, Cambridge, Mass.: Harvard University Press.

provides assurances of job security. With the low cost option, the employer unilaterally dictates working conditions rather than consulting with employees and will not hesitate to dismiss employees in order to reduce expenses.

The employees choice is one of low effort and high effort. If they select low effort, the employee will demonstrate mediocre job performance and show reluctance towards any scheme that will increase their workload. Under the high effort option, the employees will deliver what game theorists term consummate performance.[94] They will work diligently and will be willing to take the initiative to solve problems.

Given each player has two options, there are four possible outcomes to this game. By inserting admittedly arbitrary numbers into the game, it can be seen how employee protection can result in efficiency gains and yet still not be adopted.

First, if the employer selects high cost and the employee high effort, the employer s profits will be £10,000 and the monetary benefits received by the employee will also be £10,000. Second, if the employer selects low cost and the worker choose low effort, the payoffs will be £6,000 for the employer and £6,000 for the employee. Third, the employee s choose high effort but the employer chooses a low cost work environment. Here, the employer s profits will be £12,000 whereas the employees will receive £4,000. Note that the employer s profits are higher than the first outcome because he will benefit from a hard-working workforce without providing job security or other employee related expenses. The employee s benefits will be less that outcome two because they will have made sacrifices in order to deliver consummate performance whilst gaining nothing in return. Fourth, if the employer selects the high cost option and the employees select low effort, the employer s profits will be £4,000 and the employee s benefits will amount to £12,000. The employee s benefits are greater than in the other outcomes because they receive the benefits of a high cost environment whilst making the mediocre contribution of the low effort option. The employer is worse off than in the other outcomes because

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[93] This game is taken from B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, pp.578-9.

[94] On the terminology, see O. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications: A Study in the Economics of Internal Organisations*, 1975, New York: Free Press, p.69.

he will have invested resources in his high cost work environment whilst receiving only a low level of productivity.

It can be seen that in the above examples, the most efficient outcome is the high cost, high effort option since the total return will be £20,000. Under this outcome, employers would consult with their employees, provide assurances of job security and try to provide a worker friendly work environment. Accordingly, the most efficient outcome is achieved when the company protects its employees and takes their interests into account. Given this, the best overall strategy for both parties is to co-operate and take the steps necessary to reach the mutually advantageous high cost, high effort outcome.

However, this is unlikely to happen. According to game theory, both parties will be tempted to forego co-operation because of their own self-interest and will, according to the terminology, defect. The employer will have an incentive to defect because his best return (£12,000) is achieved via the low cost, high effort outcome. Therefore if he believes that his employees will work diligently, he will be tempted to forego the costs associated with the high cost option. The employee s incentive is similar since their best return (£12,000) is achieved when they select the low effort option and the employer has selected the high cost option. If both sides defect and act according to this self-interest, the employer will select the low cost option and the employees will select the low effort option. This outcome yields a total return of £12,000 — the worst overall result for both players.

The above supplies us with a justification for governmental intervention of behalf of the employees. Even when acting rationally, the employer and the employees may reach an outcome which is worst overall, even where there is ample scope for an outcome that maximises the joint welfare of both parties. The law can ensure that both parties reach mutually beneficial results by providing companies and workers with incentives to make the high cost and high effort choices. The codetermination systems examined in Chapter 4 are good examples of this.

Conclusion.

Employee protection has been on the governance agenda for several decades. Little has been done however to further the protection of employees and those measures that have been introduced have been seen to be inadequate. S.309 Companies Act 1985, examined in Chapter 4, is evidence of this. A possible reason for this lack of protection is the lack of a sound theoretical base for employee protection. This part of the chapter aimed to demonstrate that there are strong theoretical and economic reasons for expanding the scope of governance protection and increasing the protection offered to employees. Weak though it may be, the employees have an ownership claim akin to that of the shareholders. The employees, like the shareholders, can face risks due to fluctuations in corporate performance despite the fixed nature of their claims. Finally, the employees, again like the shareholders, have limited contractual protection.

For these reasons, it is argued that if the shareholders are to receive corporate governance protection, then the employees should also receive protection.

II. CREDITORS.

The Creditors as Owners.

In Chapter 2, we use Honor s test to establish that the shareholders cannot be owners of the firm. Earlier, in this chapter, we noted that using the same test, the employees also did not have an ownership claim, but that their claim was no less stronger than the shareholders. Now we will examine the position of the creditors.

As with the employees, no one is going to contend that the creditors own the firm. However, in terms of Honor s test, the creditors have an equal ownership claim to the shareholders. The creditors, like the shareholders satisfy two of Honor s 11 tests. Again, the creditors have a right to the firm s capital when sold. In fact, if the sale is the result of insolvency, then the creditors interests totally eclipse those of the shareholders. Also, the creditors enjoy the right of judgment liability whereas the shareholders do not. If the company becomes unable to satisfy the creditors claims, then the creditors can obtain a creditors winding up and satisfy their claims that way. The results are set out below:

Table 7.2: Creditor s Rights of Ownership.

Right	Me over my umbrella	Shareholder over company	Creditor over company
Possession	Yes	No	No
Use	Yes	No	No
Management	Yes	Some	No
Income	Yes	Some	No
Capital	Yes	Some	Yes
Security	Yes	No	No
Transmission	Yes	No	No
No limit of term	Yes	Yes	No
Duty not to do harm	Yes	No	No
Judgment liability	Yes	No	Yes
Residual control	Yes	Yes	No

Once again, the claim here is insufficient to justify an ownership claim, but it is no weaker than that of the shareholders.

As with the employees, it can be of aid to look at what the creditors contribute. The creditors, like the shareholders, contribute capital. The only difference is that the shareholders contribute equity capital whereas the creditors contribute debt capital. Aside form this semantic difference, their input into the firm is the same. One major difference, however, is that the shareholders input is protected by limited liability, the creditors is not. Accordingly, it has been argued that the creditors position is riskier than that of the employees. This contention will be examined next.

The Creditors as Residual Risk-Bearers.

As we saw in Chapter 6, the traditional position as regards the creditors is the same as the employees; both parties contract for fixed amounts and so therefore do not bear any risk from fluctuations in corporate performance. In Part I of this chapter, we saw that the employees can in fact suffer from residual risk through the gaining of firm-specific skills. In this part of the chapter, the creditor s position will be examined. It will also be seen that whilst creditors do contract for fixed amounts, they too can share in the risk of fluctuations in corporate performance. However, as we shall see later, they can also protect themselves to a greater degree than either the shareholders or the employees.

As we briefly noted in Chapter 4, creditors bear risk due to the existence of limited liability. Here, this risk will be examined in more detail. It will also be seen that creditors bear what is known as default risk, namely the risk that the company will not pay its debt. Both of these arguments apply when the company is insolvent or close to insolvency. Before examining these arguments, however, it is worth bearing in mind that the creditors risk can be increased even when the company is profitable.

The general position adopted by most commentators is that when the company is successful, the risks faced by the shareholders and creditors will be very low because the value of the company s equity will be rising and so the risk of default will be low. However, this is not always the case. Conflicts between the shareholders and the creditors can exist which serve to increase the creditor s risk even if the company is highly successful.[95]

Such a conflict can occur when the company transfers assets to the shareholders for inadequate consideration. Here, the shareholders will clearly benefit whereas the creditor s risk will be increased due to the reduction of capital. The same result occurs if the company pays overly high dividends. Again the members benefit from an increase in wealth, whereas the equity cushion that protects the creditors will be eroded, which will increase their risk and diminish the value of the assets available for liquidation should it occur.[96]

Another area of conflict involves the issuance of fresh borrowing. This is something that the shareholders may view favourably since it means that the members will not be asked to provide additional funding. With new funds, the company may also be able to pursue potentially profitable transactions that it could not previously afford to pursue. Existing creditors will not view the new borrowing so favourably. As their return is fixed, the possibility of higher profits will make little difference to the creditors. However, an increase in borrowing will increase the company s debt-to-equity ratio. This will dilute the claims of the existing creditors, thereby increasing the risk that they will not be paid fully.

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[95] See R.A. Posner, *Economic Analysis of Law*, 1992, 4th ed, Boston: Little, Brown, pp.394-6; M. McDaniel, *Bondholders and Corporate Governance* (1986) 41 Bus. Lawyer 413 at 418-20.
[96] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.79.

It can therefore be seen that even when the company is profitable, the shareholders have the potential to increase the risk faced by the creditors. However, the real conflict between the shareholders and the creditors occurs when the company s solvency is in doubt. It is the shareholder s position as beneficiaries of limited liability that increases the creditor s risk and it is to this that we now turn.

Creditors and Limited Liability.

Henry Manne has correctly argued that without limited liability, many small shareholders could not invest in public corporations.[97] He argues that if investors were required to supply unlimited amounts of capital, wealthy people would be reluctant to make small investments. Every equity holding, no matter how small, would place the shareholder s personal assets at risk. Manne argues that limited liability eliminates this risk.

Many commentators however, do not share Manne s view that limited liability solely minimises shareholder risk. Instead, they argue that it minimises shareholder risk by shifting the risk from the shareholders onto the creditors.[98] The theory is as follows.

There is little doubt that limited liability encourages directors to engage in risk-taking activity of behalf of the shareholders. As shareholders, as recipients of the residual income, are able to share in the gains of corporate growth without risking more than their initial investment, investment is made on the basis that those in charge will take risks in order to pursue and exploit potentially lucrative projects and ventures. [99] There is little doubt that this risk-taking is beneficial. As Sealy notes, without limited liability, the world s railways would not have been built and many of today s information technology companies would not have got off of the ground.[100] [T]he capacity to manage risk, and with it the appetite to take risks and make forward

[97] H. Manne, *Our Two Corporation Systems: Law and Economics* (1967) 53 Va. L. Rev. 259 at 259.
[98] See *e.g.* R.A. Posner, *Economic Analysis of Law*, 1992, 4th ed., Boston: Little, Brown, p.394; S.B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy and Economics* (1992) 87 Nw. Univ. L. Rev. 148 at 177-8; F.H. Easterbrook & D.R. Fischel, *Limited Liability and the Corporation* (1985) 52 Uni. Chi. LR. 89.
[99] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.541.
[100] L. Sealy, *Directors Wider Responsibilities -- Problems Conceptual, Practical and Procedural* [1987] Monash Univ. LR. 164 at 181.

looking choices, are key elements of the energy that drives the economic system forward. [101]

However, limited liability also increases the default risk faced by the creditors. Limited liability induces the shareholders to gamble with the creditor s money. Take the following example. A company has an issued share capital of £100. The directors then borrow £10,000 on the company s behalf. If the company does well, the shareholders will reap most of the benefit since they are the residual claimants. However, if things go badly, then the shareholders only lose their initial £100 investment, whereas the creditors will receive little, if any, of the £10,000 which the company owes. This temptation to gamble with the creditor s money is compounded when the company nears insolvency. It may be the case that a company cannot avoid insolvency. In such a situation, the shareholder s investment is lost, whereas the creditors will be concerned that they will not receive what they are owed. The responsible thing to do will be to wind up the company and keep any remaining funds inviolate in order to repay the creditors. Limited liability, however, creates a perverse incentive for an insolvent company to continue to trade. [102] As a company approaches insolvency, instead of winding up the company, limited liability induces the company to partake in investments which are riskier but alone offers the possibility, albeit remote, of a bonanza payoff that will prevent insolvency. [103] The rationale for this course of action derives from the shareholder s limited liability. If the risk is worthwhile and the company trades out of difficulty then the shareholders will benefit from the gains. If however, the risk does not pay off, then the shareholder s investment is lost, so any additional loses will be borne by the creditors. Because of this, investing in a limited liability company as a shareholder has been described as a heads we win, tails creditors lose situation. [104] Accordingly, shareholders have an incentive to gamble with what the creditors have at stake. [105]

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[101] H. Bernstein, *Against the Gods: The Remarkable Story of Risk*, 1996, New York: New York: John Wiley, p.3.
[102] D.D. Prentice, *Creditors Interests and Directors Duties* (1990) 10 OJLS 265 at 277.
[103] J.C. Coffee *Shareholders Versus Managers: The Strain in the Corporate Web* (1986) 85 Michigan LR. 1 at 61.
[104] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.498.
[105] J.S. Ziegal, *Is Incorporation (with Limited Liability) Too Easily Available* (1990) 31 Les Cahiers de Droit 1075 at 1081.

Despite the adverse effects that limited liability can have on creditors, neither Parliament nor the courts have abrogated the basic rule in a systematic manner that a member in a limited company is under no obligation to repay the company s debts. The only provision in the Companies Act 1985 that specifically deems shareholders to be liable to creditors is in regards to a situation where the number of members of a company falls below a prescribed minimum.[106]

Creditors and Default Risk.

The rate of return which a creditor earns if the company repays the principal and interest on time is known as the yield. The yield is fixed by the debt contract. The reason why creditors face risk is due to the fact that the yield on a debt obligation is only a promised rate of return. This is important because there is always the possibility that the debtor company will breach its obligation to repay the creditor. The possibility that the creditor will not be repaid is known as the default risk. The default risk faced by creditors increases significantly if the company is in financial trouble. Upon liquidation, the creditors have priority over the shareholders.[107] However, if the company s debts exceed its assets, not every creditor will be paid. For this reason, corporate debt is never risk-free because any company, no matter how successful it may appear to be, can fail to repay its creditors. For example, in the 1960 s, Pan American, a large American airline, was performing so well that it was taking advance bookings for its first passenger flight to the moon. By the 1990 s, however, the company was insolvent and unable to pay its creditors.

The new economic theory argues that shareholders should be the sole beneficiaries of company law protection because they are affected most by fluctuations in corporate performance, whereas other constituents contract for fixed amounts and so do not value protection so highly. However, the presence of default risk means that even though a creditor contracts for a fixed amount, the amount that he receives cannot be predicted with certainty. Instead there are a number of indeterminate outcomes from full and timely payment to complete default. This variation means that there is a

[106] S.24 Companies Act 1985.
[107] S.107 Insolvency Act 1986, which applies only to voluntary liquidations, but the same principles apply to compulsory liquidations.

volatility risk associated with corporate debt.[108] The following example demonstrates this volatility.[109]

Imagine two debt contracts. The first one provides for a twelve-month loan to a company of £10,000 at 10% interest and carries and 4% risk of default. The expected monetary value of this obligation is £10,560, which is £10,000 at 10% interest multiplied by the 96% chance of full repayment. The second debt contract is a £10,000 government bond. It has a term of a year and can be assumed to be risk-free and offers an interest rate of 5.6%. The owner of the bond will therefore receive £10,560 (£10,000 principal and £560 interest) at the end of the year. Therefore the government bond and the loan have the same expected monetary value. However, the debt obligations imposed are not the same. As the government bond has no variation of return, the creditor will receive his £10,560. The loan does not carry the same certainty as there is a 96% chance that the creditor will receive £11,000 and a 4% chance that he will receive nothing. Accordingly, even though both contracts are fixed, the risk that the creditors face is very different.

Conclusion.

It can therefore be seen that creditors also face risks and that those risks increase as the corporations fortunes dwindle. The creditors risk increases whereas the shareholders does not due to the existence of limited liability. Conversely, many commentators argue that limited liability creates an externality in that the shareholder s risks are passed onto the creditors. As a matter of risk *per se*, this conclusion cannot be doubted. The presence of limited liability and default risk increase the risks faced by creditors. In that sense, they are also residual risk bearers. However, as regards the creditors, the issue of risk is not enough to justify governance protection. This is because there are a number of steps that the creditors can take to lessen the risk or at least to ensure that they are compensated for this increase in risk. These steps will be examined in the next section.

The Inadequacies of Contract.

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[108] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.73.
[109] *Ibid.* at pp.73-4.

As we saw in the previous section, the traditional position is that limited liability serves to weaken the creditor s position. Accordingly, limited liability results in uncompensated risk being imposed on creditors who deal with the company. [110] Therefore, when examining whether the creditors need further protection, we are attempting to define what risks the creditors of a corporation have not agreed to accept in their dealings with it. [111] However, whether creditors suffer from uncompensated risk or not is open to debate.

The discussion here is concerned with the effectiveness of the various markets in protecting creditor interests. There are those who contend that the market provides creditors with all the necessary protection, whilst others argue that such forms of protection are only partially effective. We will now examine the various methods that the creditors have to protect themselves.

Before looking at the various methods of self-protection, it is worth noting that there exist market pressures that can serve to protect creditor interests. Companies will occasionally need fresh infusions of capital. If a company encounters financial difficulties, it will be unlikely to obtain this through issuing shares. It will therefore be force to obtain debt capital. In such a case, management will become dependant on the goodwill of creditors either to extend or to re-negotiate a loan and may not have a strong incentive to take action that will harm creditors interests. [112] Debtors with a history of default will find it difficult to find replacement credit. Another market pressure concerns the possibility of board removal. If a listed company encounters financial difficulties, then certain executives might be forced to leave due to pressures from the board or institutional investors. Even if this does not happen and the company is placed in receivership or wound up, the executives will probably have to step aside in favour of a licensed insolvency practitioner. Some commentators argue

[110] D.D. Prentice, *Corporate Personality, Limited Liability and the Protection of Creditors* in R. Grantham & C. Rickett (eds.), *Corporate Personality in the 20th Century*, 1998, Oxford: Hart Publishing, p.104.
[111] J. Dabner, *Trading While Insolvent-A Case for Individual Creditors Rights Against Directors* (1994) 17 UNSWLJ 546 at 574-5.
[112] L. Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors Duties to Creditors* (1993) 46 Vand. L. Rev. 1485 at 1508.

that these extra legal constraints may be more powerful than constraints created by legal rules and the risk of personal liability. [113]

The most obvious way that creditors can protect themselves is through the debt contract through the use of consensually negotiated contractual terms. As one commentator noted [a]re not bondholders, creditors, lenders and trade suppliers entitled to negotiate such creditor self protection provisions in indenture and other contractual arrangements with the corporation. [114] A typical debt contract will provide for a repayment date and the interest that is due. The interest rate that a creditor contracts for represents not only the cost of renting capital, but it also takes into account the possibility that the debtor will not repay the loan *i.e.* the default risk is a factor in determining the interest rate.[115] The following example demonstrates this.[116]

Mr. Smith decides to borrow £1 million to invest in a prospective project together with £2 million of his own money. He wants the loan for a year since by the end of that period, it will be apparent whether or not the project has succeeded. As Mr. Smith is a wealthy man and providing that he gives a personal guarantee to the bank, the bank will regard the loan as riskless and offer Mr. Smith a riskless short-term interest rate of 6%. However, Mr. Smith is reluctant to risk more than the £2 million and so proposes a different arrangement whereby the bank will agree to accept repayment exclusively from the profits of the project, if there are any, a year from the time of the loan. This way Mr. Smith can limit his liability. The bank estimates that there is an 80% probability that the project will be successful enough to repay the loan and the interest on the repayment date, and a 20% probability that the project will fail to such an extent that not even a portion of the loan will be repaid. The bank s course of action is straightforward: it must calculate the amount, payable at the end of a year, that when multiplied by 80% (the probability that payment will be made) will equal

[113] R.J. Daniels, *Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance* in J.S. Ziegal (ed.), *Current Developments in International and Comparative Corporate Insolvency Law*, 1994, Oxford: Clarendon Press, p.557.
[114] A.E. Stilson, *Re-examining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors Duties to Creditors* (1995) 20 Del. J. of Corp. L. 1 at 61.
[115] R.A. Posner, *The Rights of Creditors of Affiliated Corporations* (1975-6) 43 Univ. Chicago LR. 499 at 501.
[116] *Ibid.*

£1,060,000 (the amount that the bank would have received if Mr. Smith had made the riskless loan.) That amount is £1,325,000.[117] Accordingly, the bank will charge Mr. Smith 32.5% interest for the loan. At this rate of interest, the bank will be indifferent between the riskless and the risky loan.

The above example demonstrates that the interest rate is calculated to take into account the risk of default. Although the law allows borrowers to shift the risk onto creditors, the risk is fully compensated by the higher interest rate, *ergo* there is no externality. Voluntary creditors receive compensation in advance for the risk that the firm will be unable to meet its obligations. [118] Accordingly, if the creditor believes that default is a possibility, he can contract for a higher interest rate. For example, banks will require a higher interest rate if a borrower is not credit-worthy.[119] Accordingly, the contention that limited liability represents an externality can be dismissed. Costs are not passed onto the creditor as the creditor is fully compensated by the higher interest rate,[120] and if a creditor does not contract for a higher interest rate, the law should not support his shortsightedness.[121]

This theory can be criticised however. There are cases where the interest rate charged will fall below the level of risk undertaken, thus enabling the company to externalise the debt. This externalisation occurs for three reasons.

First, it may be the case that the market signals that borrowers look to for information on prospective creditors will not be reliable. Borrowers will regularly screen creditors. However, if the market does not have access to full information then neither will the borrower. Accordingly, without full information, the interest rate

[117] Calculated by solving $0.8x = £106$ for x.
[118] F.H. Easterbrook and D.R. Fischel, *Limited Liability and the Corporation* (1985) 52 Univ. Chicago LR. 89 at 105.
[119] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.74; R.W. Hutchinson and D.G. McKillop, *Banks and Small to Medium Sized Business Financing in the United Kingdom: Some General Issues* (1992) Feb. *Nat. West. Bank Q. Rev.* 84 at 87-8.
[120] R.A. Posner, *The Rights of Creditors of Affiliated Corporations* (1975-6) 43 Univ. Chicago LR. 499 at 503.
[121] See D.A. Wishart, *Models and Theories of Directors Duties to Creditors* (1991) 14 NZULR 323 at 335 who states that [i]f creditors do not charge for the probability of certain events happening, they should not be supported in their foolishness. They should not survive to charge less than wiser people.

charged may not reflect the actual risk. Critics point out the dubious validity of the Efficient Capital Market Hypothesis which claims:

> that all relevant information will be available to the market and that the market will rapidly, if not instantaneously, digest all information as it becomes available. [122]

If the Efficient Capital Market Hypothesis is true, then accurate pricing is possible. However, as we saw in Chapter 6, the market suffers from considerable efficiency issues and so the validity of the Efficient Capital Market Hypothesis must be doubted.

Second, the interest rate only takes into account the risk when the loan was made. During the period that the loan is outstanding, the risk of default may change. For example, the corporation may obtain additional loans not subordinated to the first one. To the extent that the change can be foreseen, it will be reflected by the interest rate at the outset. However, an unforeseen increase in risk is akin to a lowering of the rate of interest, which in turn externalises costs to the creditor.[123] To an extent this can be mitigated by the use of an amortized loan (which is repaid continuously rather than in a single payment on the repayment date).[124] Since the balance outstanding on the loan declines over time, and therefore the chance of unforeseen events arising, the lender is partially protected.

It can therefore be seen that manipulation of the interest rate can theoretically be used to compensate the creditors for the shifting of risk caused by the shareholder s limited liability. However, as we have also seen, it is an imperfect solution. There is little evidence to indicate that trade creditors in fact do alter their interest rates to accommodate changes in the default risk.[125] Thankfully, there are other mechanisms available to creditors that enable them to protect themselves.

Even before a contractual agreement is entered into, creditors have means of protection at their disposal. Creditors would be advised to screen potential debtors in

[122] J.N. Gordon and L.A. Kornhauser *Efficient Markets, Costly Information, and Securities Research* (1985) 60 NYULR. 761 at 770.
[123] J.M. Landers, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy* (1975-6) 43 Univ. Chicago LR. 527 at 530-1.
[124] R.A. Posner, *The Rights of Creditors of Affiliated Corporations* (1975-6) 43 Univ. Chicago LR. 499 at 503-4.

order to obtain information that is relevant in determining the probability of default.[126] The creditor could demand access to the company s financial statements or evidence of its past credit history. Such information will aid the creditor in determining whether or not to advance credit and, if so, on what terms. It should be remembered that creditors are not forced to lend to any one corporation. They are free to put their money in low risk investments rather than to extend credit to corporations who may default.

Creditors can diversify their debt-portfolio in very much the same manner that shareholders diversify their equity portfolios. Each debt contract will only have a small effect on the creditor s financial status. Typical lenders are accordingly well placed to absorb the loss associated with the failure of a single business. Both trade creditors and banks will be in this position because they have numerous customers. Creditors who are still concerned about the possibility of default or from sustaining a large loss from a key customer also have the option to taking out insurance. Private insurers offer cover to suppliers and manufacturers for losses arising from default by trade debtors.

Creditors may even choose to reduce the chance of default by exercising some measure of control over the company. For example, banks will often provide financial counselling. They will require access to sales forecasts and will make quarterly visits to the company in question.

However, in the ordinary course of business, most lenders do not find it worthwhile to become closely involved in corporate decisionmaking. A major reason for this is the fixed nature of the creditor s claims.[127] As, under the legal model, all the profits go to the shareholders, the creditor s return remains constant even if the company does

[125] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.501.
[126] On screening generally, see F.H. Buckley, *The Bankruptcy Priority Puzzle* (1986) 72 Va. L. Rev. 1393 at 1421-6.
[127] F.H. Easterbrook and D.R. Fischel, *Voting in Corporate Law* (1983) 26 J. of L. and Econ. 395 at 403.

well. As the creditor gains nothing extra, he has no incentive to improve the profitability of the company.[128]

The normal position therefore is that creditors have little incentive to become involved in the running of companies. However, this position can change dramatically if the company starts to encounter financial problems. The incentive to intervene is the different approaches towards risk demonstrated by shareholders and creditors due to the existence of limited liability.

The point that needs to be emphasised is that as the company nears insolvency, the creditors will become risk-averse whereas the company has an incentive to adopt riskier projects in order to ensure survival. Suppose that a company is deeply in debt and that the creditors, either through a provision in the debt contract or through legislation, have the power to take control of the company and sell off its assets.[129] However, the company has developed a new product which will be successful in the market place. Two marketing approaches have been put forward. First, the company could market the product cautiously and sell the product at a price which will secure reasonable sales. This will allow the company to pay off a considerable portion of what it owes, but the creditors will still want to close the company down in order to secure the remaining debt. Second, the company could market the product aggressively and sell the product at a discounted price in order to secure high sales. It is unclear whether or not the product is popular enough to warrant such a sales strategy. However, if this strategy works out, then the company will be able to fully pay its debts and carry on trading. There is little doubt that the creditors will prefer the cautious strategy as this approach should ensure that the debt is repaid. Further, if the gamble on the aggressive approach fails, the company will be deeper in debt. Conversely, the shareholders will favour the aggressive strategy because this could result in a restoration of their equity value. If the gamble does not pay of, then, by virtue of their limited liability, they will not be liable for the additional debts that the company will gain. Given this, as the company nears insolvency, the creditors have a

[128] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.75.
[129] Creditors who have managed to obtain security over their loans will often contract for the right to appoint a receiver to enforce their security. They also have a right to apply for a winding up order under s.124 Insolvency Act 1986.

stronger incentive to intervene in managerial affairs so that the default risk that they face is not increased due to the shareholder s desire to undertake risky ventures.

Finally, creditors can contract for some kind of security. Large creditors, such as banks, will be able to protect themselves via such mechanisms as personal guarantees and reservation of title clauses. However, not all creditors are in a position to insist upon such security. For example, trade creditors will probably not be in a position to demand security and so will be unable to contractually protect themselves.[130] Furthermore, pressing for contractual protection may be counter-productive as the company may take its business elsewhere, particularly if they believe that another creditor will offer less restrictive terms. Such competitive pressures often force creditors to forego such protective measures.[131]

This is well illustrated with regards to the position of trade creditors. Trade creditors do not typically alter their standard loan agreements to take into account the risk of default.[132] Pedantry in such a situation could cost the creditor business. Further, since most trade creditors will have many customers, it would simply be too time consuming to monitor compliance.

Conclusion.

Like the employees, there is no doubt that creditors, like the shareholders, bear the risk that their interests will be affected by fluctuations in corporate performance. In this sense, the theory behind the legal model and the new economic theory is flawed. However, in relation to creditors, an examination of the risk they face is not enough to justify corporate governance protection. There is no doubt that the existence of default risk can severely prejudice creditors. However, the creditors are fully aware of this and indeed accept it. The risk is a normal one, a background presence in every transaction. [133] As Sealy notes creditors deal with a company as a matter of

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[130] J.S. Ziegal, *Creditors as Corporate Stakeholders: The Quiet Revolution - An Anglo-Canadian Perspective* (1993) 43 Univ. Toronto LJ. 511 at 530.
[131] B.R. Cheffins, *Company Law: Theory, Structure and Operation*, 1997, Oxford: Clarendon Press, p.81.
[132] L.A. Bebchuk and J.M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy* (1996) 105 Yale LJ. 857 at 886-7.
[133] I. Flynn, *Statutory Liability for Culpable Mismanagement* in H. Rajak (ed.), *Insolvency Law Theory and Practice*, 1993, London: Sweet & Maxwell, p.135.

bargain, not of trust, and bargain involves risk. [134] Accordingly, the creditors accept the risk of default risk.

If the risk faced by the creditors was uncompensated or there was no way for them to protect themselves, then they would be as deserving as the shareholders and the employees in determining the scope of corporate governance protection. However, we have seen that the risk faced by the creditors is not always uncompensated in that the interest rate compensates the creditor in advance for the possibility of default. We have also seen that there are various strategies available to creditors in able to protect themselves.

However, the above is not true of all creditors. Many trade creditors will not be able to obtain an interest rate concession due to competitive pressures. Their ability to extract contractual protection will also be low due to inequalities of bargaining power. Accordingly, it is certainly the case that certain creditors are more deserving of protection than others. Also, irrespective of the above, as the company nears insolvency, the position of all creditors can be adversely affected by incentives created as a result of the shareholders limited liability. However, there is no doubt that the risk faced by creditors as the result of such incentives has been exaggerated.[135] The vast majority of creditors are promptly paid. If this were not so, the credit system would be radically different than it is today; in fact it might not even exist.[136] Therefore, it is to be hoped that any future legal protection aimed at creditors is aimed at those creditors most deserving.

CONCLUSION.

In the previous chapter, we examined three traditional arguments advocated for the legal model presumption that corporate governance protection should be exclusively available to shareholders. We saw that in relation to shareholders, with the exception of the weakness of contract argument, they are insufficient to justify the level of

[134] L.S. Sealy, *Directors Wider Responsibilities-Problems Conceptual, Practical and Procedural* [1987] Monash. Univ. LR. 164 at 176.
[135] F.H. Easterbook & D.R. Fischel, *Limited Liability and the Corporation* (1985) 52 Univ. Chicago LR. 89 at 104.

shareholder protection that we currently have. This chapter aimed to take the argument one step further and contend that these arguments can be used to justify governance protection for the two most obvious non-shareholder constituents, namely the employees and the creditors.

It can be seen that the position of the employees and creditors is in many ways similar to that of the shareholders. All three parties have ownership claims, although none of them strong enough to establish ownership of the firm. All parties can be adversely affected by fluctuations in corporate performance. Therefore all parties face greater or lesser degrees of risk. Finally, all parties have a limited ability to protect themselves contractually. Traditional theorists argue that if contractual protection is limited then the law should step in to fill in the gaps. We have seen that the ability of employees and creditors to protect themselves is limited, albeit not as limited as the shareholders.

For these reasons, it is contended that the protection offered to employees and creditors needs to be strengthened. Part of this strengthening will involve making it clear to directors that it is permissible to act in the interests of these non-shareholder constituents. This will be needed because it is still not clear whether or not corporate social, profit sacrificing behaviour is lawful. This issue will therefore be examined in the next chapter by examining the lawfulness of the most extreme form of profit sacrificing behaviour, namely corporate philanthropy.

[136] D.D. Prentice, *Corporate Personality, Limited Liability and the Protection of Creditors* in R. Grantham & C. Rickett (eds.), *Corporate Personality in the 20th Century*, 1998, Oxford: Hart Publishing, p.99.

8

The Lawfulness of Departure from the Legal Model.

INTRODUCTION

Discussions surrounding the topic of corporate social responsibility tend to proceed upon the assumption that it is in the social interest that companies act for constituents beyond those who own stock, be that via the traditional legal model aim of profit-maximization[1] or via corporate acts designed specifically to benefit non-shareholder constituents. The move towards corporate social responsibility is characterized by a shift in the attitudes of traditional theorists. No longer prioritizing profit-maximization over corporate social responsibility, there is now an indication that these theorists view profit maximization as a long-term source of corporate social responsibility.[2] Accordingly, corporate philanthropy is increasingly being viewed as within the proper ambit of the corporations activities.

However, a crucial element of this debate is often ignored, namely the lawfulness of acts which diverge from the traditional aim of profit-maximization. Asking whether or not a company may act in a socially beneficial way may seem to be an irrelevant question. After all, corporate donations, political, profit-motivated and altruistic, are regularly publicized, often disclosed[3] and often serve to eschew the view that the corporation is concerned solely with the interests of shareholders irrespective of the effect on society. The question is, however, not only valid but could actually serve to enlighten an issue that has still not adequately been resolved, namely the lawful role of the corporation.

The situation as regards the lawfulness of corporate social responsibility was first brought to the fore by Dodd in the aforementioned Harvard Debate when he stated:

> The view that those who manage our business corporations should concern themselves with the interests of employees, consumers and the general public, as

[1] For example, advocates of the new economic theory of the firm would argue that societal wealth is maximised when each party contracts for their own well being. If contracts are optimally beneficial for each party, collectively societal wealth-creation is maximised.

[2] A view that has become known as the enlightened shareholder value approach. See the Department of Trade and Industry, *Modern Company Law for a Competitive Economy: The Strategic Framework*, February 1999, London: HMSO, para.5.1.12.

[3] S.234(4) and Sch.7 Part I-V Companies Act 1985.

> well as the stockholders, is thus advanced today by persons whose position in the business world is such as to give them great power of influencing both business opinion and public opinion generally. Little or no attempt seems to have been made, however, to consider how far such an attitude on the part of corporate managers is compatible with the legal duties which they owe the stockholder-owners as the elected representatives of the latter. [4]

The separation of ownership and control and the subsequent freedom of the managers from shareholder control has enabled the directors to adopt goals divergent to profit-maximization.[5] Ultimately, the Harvard Debate ended, at least on paper, when Berle stated that the argument between him and Dodd has been settled (at least for the time being) squarely in favor of Professor Dodd s contention. [6] In justifying this position, Dodd relied heavily on cases permitting corporate philanthropy.[7] Corporate philanthropy constitutes the most obvious departure from the legal model in that it is supposedly totally altruistic. If philanthropic acts can be perceived as lawful, then any act that departs from the legal model goal of profit maximisation (in other words, acts that benefit non-shareholder constituents) can also be viewed as lawful. Accordingly, much of what will be examined will relate to philanthropic acts, but will also apply to any act that does not benefit shareholders and therefore is perceived as departing from the legal model.

I. AN HISTORICAL PERSPECTIVE

In *Hutton v West Cork Railway Co.*,[8] Bowen LJ held that there should be no cakes and ale except such are as required for the benefit of the company. [9] This quote has been interpreted by some academics to mean that corporate philanthropy was expressly forbidden. This was not the case, as the full quote reveals:

> The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company . [A]s it seems to me, charity has no business to sit at boards of directors qua charity. [10]

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[4] E.M. Dodd Jnr., *For Whom are Corporate Managers Trustees?* (1931-32) 45 Harv. L. Rev. 1145 at 1156.
[5] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, Ch. 9.
[6] A.A. Berle, *The 20th Century Capitalist Revolution*, 1954, New York: Harcourt, Brace and Company, p.169.
[7] L.C.B. Gower, *Corporate Control: The Battle for the Berkeley* (1954-55) 68 Harv. L. Rev. 1176 at 1191.
[8] (1883) 23 Ch.D. 654.
[9] *Ibid.* at p.673.
[10] *Ibid.*

Although the distinction is fine, it nonetheless exists. Acts in which the company did not benefit *per se* was not permitted, irrespective of their merit.[11] However, a philanthropic act, which in some way benefited the company, would be permissible. This was admitted by Bowen LJ in *Hutton* when he cited the case of *Hampson v Price s Patent Candle Co*.[12] In *Hampson*, a company with no express power to pay gratuities was held to be acting within its powers when it paid a bonus of one weeks wages to its employees. Bowen LJ believed that such a bonus eases the friction between masters and servants, and is, in the end, a benefit to the company. [13]

Accordingly, the starting point, at least regarding the history of corporate departure from the legal model, was that the directors owed their duties to the shareholders, albeit in an indirect manner, and this was manifested by a policy of profit-maximization; a policy that has proved to be extremely resistant to change. It seems to have been accepted practically without question until only a decade or two ago that the sole purpose of any company was to make the greatest possible profits for its shareholders. [14]

II. AN OVERVIEW OF THE LAW

As may have been deduced, the judiciary has propagated the corporations role as a profit-maximizing institution. Until recently, statute had little part to play. In the UK, in the absence of statutory authority, the issue has come to be governed by the common law rules of *ultra vires*. Despite the fact that this doctrine has been heavily emasculated,[15] it still has a role to play as regards actions that are outside the company s objects.[16]

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[11] *Parke v Daily News Ltd.* [1962] Ch. 927.
[12] (1876) 45 LJ Ch. 437.
[13] (1883) 23 Ch.D. 654 at 673.
[14] L.S. Sealy, *Cases and Materials in Company Law*, 1992, 5th ed., London: Butterworths, p.157.
[15] It is contended that to describe the *ultra vires* rule as abolished, as many academics tend to, is incorrect.
[16] S.35(3) Companies Act 1985 provides that:

> 35(3) It remains the duty of the directors to observe any limitations on their powers flowing from the company s memorandum; and action by the directors which but for subsection (1) would be beyond the company s capacity may only be ratified by the company by special resolution.

Historically, a company could not be bound by actions that were outside the company s objects.[17] However, this proved to be extremely harsh on third parties innocently contracting with the company, who would find their contracts invalid. Accordingly, s.108 Companies Act 1989 abolished the hazards faced by innocent third parties whilst retaining the director s liability.[18] Though in recognising the realities of commerce, both the transaction and the directors exoneration can be subsequently ratified by a special resolution.[19]

III. CORPORATE DONATIONS

Despite the uncertainty concerning the role of the corporation, charitable giving is widespread. Unlike less tangible forms of corporate philanthropy, corporate donations are readily quantifiable due to the company s obligation to disclose such donations in the company accounts.[20] Further publicity is provided by the Charities Aid Foundation (CAF) who annually publish lists of the significant corporate donors. In 1991/92, the 213 responding companies donated nearly £85 millions.[21] Twenty-three companies gave over a million pounds each, and twelve over two millions.[22] The figures for the following year are even more impressive. One hundred and sixty-three of the top 500 companies gave £149.8 millions to charity.[23] Corporate charitable altruism is therefore seen as a conventional part of business life, although when compared to the total amount of donations derived from households in 1989/90, a figure estimated as between £3.4 and £5 billions, corporate donations appear less significant.

Despite the fact that the practice of corporate giving is universal, particularly amongst large listed companies, its lawfulness is uncertain. Further, all the leading cases in

[17] Ashbury Railway Carriage & Iron Co. Ltd. v Riche (1875) LR 7 HL 653.

[18] The reformed rules on *ultra vires* are now contained in ss.35 and 35A Companies Act 1985. These provisions came about due to the UK s inclusion into the European Community, most notably s.9 European Communities Act 1972 which was itself based on Art.54 Treaty Establishing the European Community.

[19] S.35(3) Companies Act 1985.

[20] S.234 and Sch.7 Part I Companies Act 1985.

[21] Charities Aid Foundation, *Charity Trends*, 1992, 15th ed., Tonbridge: The Charities Aid Foundation, pp.54-6.

[22] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.290.

[23] S.K.E. Saxon-Harold & J. Kendall (eds.), *Dimensions of the Voluntary Sector*, 1995, Tonbridge: The Charities Aid Foundation.

this area were decided before the *ultra vires* reforms contained in the Companies Act 1989, although it is acknowledged that this may make little difference. Case law has held that such donations may sometimes be permissible, as in the case of *Evans v Brunner Mond & Co. Ltd.*,[24] and sometimes not, as in *Tomkinson v South Eastern Railway Co.*[25] and the more recent case of *Simmonds v Heffer.*[26]

In *Evans*, the shareholders authorized the directors to make donations totaling £100,000 to such universities, or other scientific institutions in the United Kingdom as they may select for the furtherance of scientific education and research. The reason advocated for the donations was that the company hoped that the donations would eventually ensure access to a larger and better-trained pool of personnel from which to recruit future staff. The company therefore saw a direct causal link between the donation and the company s welfare; that the cakes and ale were for the company s benefit. One shareholder disagreed and challenged the resolution on the basis that the community at large was the true beneficiary, and that the company, as part of the community, may derive some distant, remote and more or less insignificant benefit but a benefit out of all proportion to the cost. [27] The court agreed with the director and held the resolution valid. The court stated that the donation was neither too remote nor too speculative for the company to accrue benefit.

The question that arises is how did the court come to such a decision. Unlike their French counterparts,[28] British judges will not assume an investigative function. Even if they did, the benefit accrued would be incapable of quantification, both financially and temporally. Accordingly, the court was in no position to assess the long-term benefits accrued from the donation. It is therefore no surprise to discover that this case has been commented upon as depending on little more that a judicial guess. [29]

[24] [1921] 1 Ch. 359.
[25] (1887) 35 Ch.D. 675.
[26] [1983] BCLC 298.
[27] [1921] 1 Ch. 359 at 365.
[28] See A. Tunc, *The Judge and the Businessman* (1986) 102 LQR 549 at 555 who notes that it is inconceivable that a judge [in a French court] would state that business decisions are the sole province of the board.
[29] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.274.

In *Evans*, the sole question was did the donation confer a benefit to the company. However, in the earlier case of *Tomkinson*, it was held that not only must there be a benefit to the company, but there must also be a thematic connection between the donor and donee. Here, the South-Eastern Railway Company attempted to donate £1,000 towards the construction of the Imperial Institute. The company contended that the attendance to such events might result in an increase in railway traffic. In declaring the donation *ultra vires*, Kay J held:

> To say that any expenditure which may indirectly conduce to the benefit is *intra vires*, seems to me extravagant. [30]

Accordingly, it was held that it was not within the objects of a railway company to donate monies to sporting events.[31] Although never overtly overruled, given the changes in the *ultra vires* laws, it is unlikely that this case still represents good law.

Similar reasoning was applied in the more recent case of *Simmonds v Heffer*.[32] In this case the company was the League Against Cruel Sports Ltd., a company set up to oppose cruelty to animals. The company made two donations to the Labour Party: a general donation to the party s electoral fund worth £50,000 and a specific donation worth £30,000 to help fund publicity for the party s manifesto pledge to criminalise certain blood sports. The League sought to rely on three paragraphs located in its objects relating to the opposition of animal cruelty.

The specific donation was upheld, the general donation was not. The specific donation furthered the League s object of opposing cruelty. Conversely, the general donation was struck down because the money could have been spent on policies unrelated to the opposition of blood sports. The court stated that the above provisions in the memorandum were not objects, but powers incidental to the true objects of the company. [33]

These cases must now be read in light of the reforms brought in by the Companies Acts 1985 and 1989. Prior to 1989, it was unclear whether or not gratuitous donations

[30] (1887) 35 Ch.D. 675 at 680.
[31] Today, such a donation could be justified as a form of advertising. See D. Wragg, *The Effective Use of Sponsorship*, 1994, London: Kogan Page, Marketing in Action Series; C. Gillies, *Business Sponsorship*, 1991, Oxford: Butterworths Heinamann.
[32] [1983] BCLC 298.

were made *intra vires* by the 1985 Act. Farrar contended that dealing normally predicated reprocity and asked whether the language of the former s.35 was wide enough to cover a corporate gift or other gratuitous donation it is arguable that it should not. [34] The former s.35 was also the subject of judicial consideration in the case of *Re Halt Garage*[35] where the court stated:

> In any event, the view is expressed in *Gore-Browne on Companies* (43rd edn, 1977) paras 3-16, that the recipient of a corporate gift is not a person dealing with the company within the meaning of the section and that those words contemplate a contractual relationship. [36]

This confusion has been cleared up by the reformed s.35A(2)(a);[37] a provision included following the recommendations of the Prentice Report,[38] so that the recipients of gratuitous donations are afforded the same protection as others who deal with the company.

The question that now occupies us is to what extent, if any, does the doctrine of *ultra vires* still exist. S.108 Companies Act 1989 altered the provisions of the 1985 Act so as to lessen the burden upon innocent third parties. As a result of these changes, the company s capacity is no longer limited by the objects clause.[39] Despite this, however, the shareholders right to restrain directors from entering into an act outside the objects of the company is retained.[40] Therefore, should the shareholders discover that the directors plan to depart from the legal model and benefit a non-shareholder constituent, and this is not authorised by the objects, then the shareholders can obtain an injunction to stop this act. Accordingly, in a reduced, but nonetheless important sense, the *ultra vires* doctrine still survives. Therefore, the older cases concerning *ultra vires* still have a role to play.

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[33] *Ibid.*

[34] J.H. Farrar, N.E. Furey & B.M. Hannigan, *Farrar s Company Law*, 1991, 3rd ed., London: Butterworths, p.112.

[35] [1982] 3 All ER 1016.

[36] *Ibid.* at p.1039, *per* Oliver J.

[37] 35A(2)(a) [Interpretation] (2) For this purpose (a) a person deals with the company if he is party to any transaction or other act to which the company is a party

[38] DTI, *Reform of the Ultra Vires Rule: A Consultative Document*, 1986, London: DTI.

[39] S.35(1) Companies Act 1985:

> 35(1) The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company s memorandum.

[40] S.35(2) Companies Act 1985.

As has been noted, in order for a donation to be *intra vires*, it had to benefit the company. This nebulous rule was refined in the case of Re Lee Behrens.[41] Here, the directors of the company covenanted on behalf of the company to pay a pension to the widow of a former managing director. No general meeting was convened to discuss the proposal and no power was conferred on the company by its objects to make such a payment. However, the case of *Henderson v Bank of Australasia*[42] established that a trading company continuing in business had an implied power to make such a gift. In coming to his decision, Eve J said that the validity of any gift had to be tested by the answers to three pertinent questions: (i) Is the transaction reasonably incidental to the carrying on of the company s business? (ii) Is it a bona fide transaction, and (iii) is it done for the benefit and to promote the prosperity of the company. [43] In finding the payment invalid, Eve J held that the directors had not considered whether or not the payment was beneficial to the company. The fact that the directors had not put the payment to a general meeting was evidence of this.

Subsequent cases[44] have demonstrated, however, that the Lee Behrens tests contain a substantial lacuna, namely where the company has a substantive, non-commercial object. In *Re Horsely & Weight Ltd.*,[45] Buckley LJ stated that the:

> objects of a company do not need to be commercial; they can be charitable or philanthropic; indeed, they can be whatever the original incorporators wish, provided that they are legal. Nor is there any reason why a company should not part with its funds gratuitously or for non-commercial reasons if to do so is within its declared objects. [46]

It should be pointed out that the majority of companies will not have such an object, and therefore, a gratuitous disposition of assets will only be valid if it falls within an express or implied power. If the company does, however, contain such an object[47]

[41] [1932] 2 Ch. 46.
[42] (1888) 40 Ch.D. 170.
[43] [1932] 2 Ch. 46 at 51.
[44] There is judicial inconsistency as to the validity of Re Lee Behrens. In the landmark case in this area, *Rolled Steel Products (Holdings) Ltd. v British Steel Corporation* [1985] 3 All ER 52 at 80-1 Slade LJ stated that the Lee Behrens test should, in my opinion, now be recognized as being of no assistance. However, the same judge in the same case, later said that it may well be helpful in considering whether or not in any given case directors have abused the powers vested in them by the company.
[45] [1982] 3 All ER 1045.
[46] *Ibid.* at p.1052. In this case, the object in question gave the company power 3(o): to grant pensions to employees and ex-employees and directors and ex-directors
[47] Hanson PLC, one of the UK s largest companies, has an object to support and subscribe to any body of persons or trust established for the advancement of education or carrying on any educational establishment. The Body Shop International PLC contains four such objects: (B) To institute and

then, theoretically, there can never be a problem of the donations being authorized. The word theoretically is used because for a time the situation was unclear. In Charterbridge Corporation Ltd. v Lloyds Bank,[48] the court suggested that even if the company had an express non-commercial object, the directors would still have to act in a *bona fide* manner.[49] Likewise, in Brady v Brady,[50] Nourse LJ suggested that the *ratio* of Re Horsely might be restricted in its application:

> In its broadest terms the principle is that a company cannot give away its assets. So stated, it is subject to the qualification that in the realm of theory a memorandum of association may authorise a company to give away all its assets to whomsoever it pleases, including its shareholders. But in the real world of trading companies, charitable or political donations, pensions to widows of ex-employees and the like apart, it is obvious that such a power would never be taken. The principle is only a facet of the wider rule, the corollary of limited liability, that the integrity of a company s assets, except to the extent allowed by its constitution, must be preserved for the benefit of all those who are interested in them, most pertinently its creditors. [51]

The situation, at least for the time being, has now been clarified in the case of Rolled Steel Products (Holdings) Ltd. v British Steel Corporation.[52] In this case, Browne-Wilkinson LJ held:

> the use of the phrase ultra vires should be restricted to those cases where the transaction is beyond the capacity of the company and therefore wholly void . [I]t is clear that a transaction falling within the objects of the company is capable of conferring rights on third parties even though the transaction was an abuse of the powers of the company [53]

This case, decided before the 1989 reforms, was the first step in the abolition of this doctrine against third parties.

At this point, a summary of the current position will be of use. If the company has an express non-commercial object, then the shareholders will be unable to sustain an action under ss.35 and 35A Companies Act 1985, either before or after the transaction

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support (whether by donation or otherwise) campaigns or educational programs for human and civil rights [and] community projects. (C) To establish and develop equitable and responsible trading relationships, particularly in respect of community economic initiatives. (D) To implement policies aimed at protecting the natural environment (E) To institute and support campaign against animal testing.

[48] [1970] Ch. 62.

[49] The proper test, I think must be whether an intelligent and honest man in the position of the directors of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company. *Ibid.* at p.74. *per* Pennycuick J.

[50] [1988] BCLC 20.

[51] *Ibid.* at p.38.

[52] [1986] Ch. 246.

has taken place. If there is no express authorizing object then unless the donation is incidental to the company s business and beneficial to the company, the court will not imply a power. Where no power exists, the court will not imply one. In such a case, the shareholders will be unable to invalidate a transaction that has already taken place, but will be able to enjoin a prospective donation or hold the directors liable under s.35(3) after the transaction.

It can therefore be seen that, in relation to the *ultra vires* rule, acts that depart from the legal model of the company are permissible providing that there is a provision in the objects permitting such departure. However, even if there is no such provision, once such an act has become a legal obligation, then it will still be valid, although the directors will be liable for breach of duty under s.35(3).

Unlimited Objects Clauses and the Impact of s.3A Companies Act 1985.

In *Re Introductions Ltd.*,[54] Harman LJ held that you cannot have an object to do every mortal thing you want, because that is to have no object at all. [55] Theoretically, in the light of s.3A Companies Act 1985, that is now possible.

It has been a long held tenet of company law that each company must contain within its memorandum, a set of object clauses.[56] The judiciary s attitude has been that the objects exist in order to delineate the activities of the company, to limit the company s power. Referring to the Companies Act 1948, Lord Wrenbury held:

> I cannot doubt that when the Act says that the memorandum must state the objects the meaning is that it must specify the objects, that it must delimit and identify the objects. [57]

Accordingly, a set of objects that set out to be limitless would not be lawful. As far back as 1890, North J stated that:

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[53] *Ibid.* at p.303.
[54] [1970] 1 Ch. 199.
[55] *Ibid.* at p.209.
[56] S.2(1)(c) Companies Act 1985. The DTI Company Law Review Steering Group s Report *Modern Company Law for a Competitive Economy: The Strategic Framework*, February 1999, London: DTI, para.5.3.18 recommends that this requirement be abolished for new companies and existing companies should have the option to retain or abolish. Shareholders would be free to enact any restrictions they wish in the form of objects. Following ss.117 and 125 Company Law Review Act 1998, Australian companies can now be formed without a constitution.
[57] *Cotman v Brougham* [1918] AC 514 at 522.

> If the memorandum were to state, as the objects of the company, that it was to carry on any business whatever which the company might think would be profitable to the shareholders, in my opinion that would not be a statement of the objects of the company as required by the Act. [58]

However, since the conception of the requirement that the objects must delineate the powers of the company, this principle has been judicially sapped [59] by the courts. Here, the cases that emasculated this principle will be examined culminating with an analysis of s.3A, a provision that theoretically eliminates this requirement. For present purposes, the importance of unlimited objects should not be underestimated. If they are indeed lawful, then this is equivalent to parliamentary permission that the company may engage in almost any activities that it wishes, including acts of corporate philanthropy.

Judicial erosion of this principle derived from the High Court of Australia in the case of *HA Stephenson & Son Ltd. v Gillanders Arbuthnot & Co.*[60] Here, the appellant company was formed to carry on the trade of produce merchant in Western Australia. It contracted with the respondent company in Calcutta for the purchase of jute. The contract was not explicitly authorised by the objects but clause (j) gave the company power: [t]o carry on any other business whether manufacturing or otherwise as the company may deem expedient. The question was whether the jute purchases were made *intra vires* by this provision.

In holding the purchase valid, Dixon J held:

> The true meaning of the object would appear to be to authorise the company to carry on any business found to be connected or associated with any existing business of the company . Wide as such a definition is, it does not appear to be considered too indefinite to pass muster as a lawful object, and upon this memorandum no greater restriction of the general words is justified [61]

These subjective objects were upheld in the UK in the landmark case of *Bell Houses Ltd. v City Wall Properties Ltd.*[62] Here, both companies were property developers. The plaintiff company introduced the defendants to a financier who provided them with a bridging loan of £1 million. In return for this introduction, the defendants

[58] *Re Crown Bank* (1890) 44 Ch.D. 634 at 644.
[59] S. de Gay, *Problems Surrounding Use of the New Single Objects Clause* (1993) 137 SJ 146 at 146.
[60] (1931) 45 CLR 476.
[61] *Ibid.* at p.491.
[62] [1966] 2 QB 656.

agreed to pay the plaintiffs £20,000. The defendants reneged on this fee arguing that a mortgage-broking transaction such as this was outside the plaintiff company s objects. The plaintiff company had no express term authorising the transaction but sought to rely on clause 3(c) which stated: To carry on any other trade or business whatsoever which can, in the opinion of the board of directors, be advantageously carried on by the company in connection with or as ancillary to the general business of the company. At first instance, Mocatta J upheld the defendant s contention that the transaction was *ultra vires*, with the consequence that the plaintiff went unrewarded for their part in the transaction. The plaintiffs appealed and the Court of Appeal reversed the decision.

In holding the transaction *intra vires*, Salmon LJ held that:

> An object of the plaintiff company is to carry on any business which the directors genuinely believe can be carried on advantageously in connection with or ancillary to the general business of the company. It may be that the directors take the wrong view and in fact the business in question cannot be carried on as the directors believe. But in matters not how mistaken the directors may be. Providing they form their view honestly, the business is within the plaintiff company s objects and powers. [63]

The significance of the above two cases is considerable. In effect, they permit subjective open-ended objects allowing the directors to partake in activities not overtly covered by the objects. Accordingly, the objects clause no longer delineates the powers of the company. However, these cases do not approve unlimited objects clauses. In both <u>*HA Stephenson*</u> and <u>*Bell Houses*</u>, the court explicitly stated that in order for a transaction to be valid, it must be connected in some way with the business of the company. Therefore, what these two cases have introduced in effect is a class of subordinate objects clause derived from the original objects. They are akin to the relationship between primary and secondary legislation: they have the same level of authority but the existence of the subordinate is defined and fully dependent on the scope and existence of the primary.

The position at this point is that in order for an act to be valid it must either (a) be explicitly permitted by the objects clause, or; (b) be believed by the directors that such an act is connected to the company and can be carried on advantageously. This

[63] *Ibid.* at p.690.

position was, however, complicated by the case of Newstead (Inspector of Taxes) v Frost.[64]

This case involved the television presenter David Frost. As part of a scheme designed to reduce the amount of tax paid on overseas earnings, he entered into a partnership agreement with a company in the Bahamas. The General Commissioners found the partnership valid with the result that he was only taxed on sums remitted in the UK. The Inland Revenue appealed on the grounds that the company was acting *ultra vires* in entering into the partnership.

The case revolved around memorandum clause 3(6), which authorized the company:

> To carry on any business as bankers, capitalists, financiers, concessionaries and merchants and to undertake and carry on and execute all kinds of financial commercial trading or other operations and generally to undertake and carry out all such obligations and transactions as an individual capitalist may lawfully undertake and carry out.

The difficulties arose concerning the meaning of the phrase other operations. In the House of Lords, Viscount Dilhorne said:

> I doubt if the business of the partnership is properly to be described as a commercial operation, but if it is not a financial or commercial operation it certainly is covered by the words all kinds of other operations.[65]

This is the problematic area. As stated earlier, any activity not covered by the objects must be connected to the objects in some way. Here, it is unclear whether the other operations need be connected to the substantive objects. If they do not, then the company will be able to partake in any lawful activity, thereby ensuring that detailed objects would be irrelevant. Given that his lordship makes this exact point, one is led to believe that this is the conclusion arrived at:

> It is true that if they are given an unlimited meaning it is hard to see the purpose of the other words in clause 3 (6) or indeed the object of including the other paragraphs of clause 3 for a statement that the object of the company was to carry on and execute all kinds of operations would cover all the other stated objects.[66]

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[64] [1980] 1 WLR 135.
[65] *Ibid.* at p.141.
[66] *Ibid.*

Ultimately, the position is unclear. There is no House of Lords decision on the matter and until the position is clear, companies will continue to use elaborately detailed objects. As we shall see, this is even so despite the introduction of a general objects clause.

As we have seen, the *ultra vires* doctrine underwent a considerable emasculation following the Companies Act 1989. As part of this process, the Act introduced a provision permitting the company s memorandum to state that the object of the company is to carry on business as a general commercial company. According to s.3A Companies Act 1985[67] this means:

> (a) the object of the company is to carry on any trade or business whatsoever, and
> (b) the company has power to do all such things as are incidental to the carrying on of any trade or business by it.

Some have assumed that the intention of Parliament in introducing this provision was to encourage companies to curtail from drafting long detailed objects clauses. In fact, in line with the reforms contained in the 1989 Act, the adoption of s.3A will mean that the company will effectively have opted out of the ultra vires rule for internal purposes. [68] However, for reasons that will be examined, poor drafting has led to a situation where the new provision is little used, or where it is used, it is still used in conjunction with detailed objects.[69]

S.110 Companies Act 1989 was introduced relatively late in the Act s passage through Parliament. Accordingly, it escaped thorough scrutiny. This explains why the Act contains several phrases and words that are highly ambiguous, and more importantly for our purposes, the wording of the Act appears to oppose corporate philanthropy.

Firstly, there is uncertainty as to what is meant by the words trade and business. If a literal approach is adopted, then corporate philanthropy will not appear to be covered. The objects clause will permit all kinds of profit-making activity, but not

[67] Introduced by s.110 Companies Act 1989.
[68] Lord Strathclyde, *Hansard*, 21[st] February 1989.

activity that departs from the profit goal. This is upheld by the use of the phrase general *commercial* company. If this is the case, then companies that have at their heart charitable activities, for example charitable or holding companies, may be precluded from using the new objects clause.[70] If this interpretation is correct, then it can be said that s.3A directly upholds the legal model by not permitting non-profit making activity. Conversely, a more liberal approach may be adopted in which the words trade or business may also include activities that are not reciprocal of profit led.

Secondly, regardless of the meaning of the words trade or business, the company can engage in *any* activity within its field of trade. What this means is that there is no longer a need for subjective objects clauses such as those found in the *Bell Houses* line of authority.

Finally, s.3A applies where the company s memorandum states that *the* object of the company is to carry on business as a general commercial company. The use of the word the implies that the s.3A objects clause should be the only stated object. However, this has not been the case. Due to its uncertain nature, s.3A is used in conjunction with the very protracted objects that it was enacted to replace.

The above problems ensure that s.3A is not going to form part of the new Companies Act. In its opening document, the Company Law Review Steering Group looked at s.3A under the heading Obsolescent or Ineffective Provisions. [71]

The Role of the Directors Fiduciary Duties.

The *ultra vires* doctrine is but one part of a two-part test of validity. The second constraint on director s power derives from their position as fiduciaries. It should be noted here that there is a blurred relationship between the *ultra vires* doctrine and the

[69] The most recent report to state this is the DTI Company Law Review Steering Group s Report *Modern Company Law for a Competitive Economy: The Strategic Framework*, 1999, HMSO, para.5.3.17.
[70] S. de Gay, *Problems Surrounding Use of the New Single Objects Clause* (1993) 137 SJ 146 at 146.
[71] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy*, March 1998. London: DTI, para.3.4.

directors fiduciary duties. Even if a donation is *intra vires*, it may still be invalidated if the directors are found to have breached their fiduciary duties.

The objects clause in the company s memorandum states the activities for which the company has been formed, although these may be altered by special resolution.[72] Conversely, the fiduciary controls on managerial autonomy place a duty on the directors to act indirectly in the interests of the shareholders, a duty resulting from the private conception of the company and company law. The shareholders own the company[73] and therefore have a right to expect it to be run in their own interests.

In Re Smith & Fawcett Ltd.,[74] Lord Greene MR held that directors must act:

> bona fide in what they consider-not what a court may consider-is in the interests of the company, and not for any collateral purpose. [75]

At one point, this was held to be one test alone. Providing that the directors honestly believed that they were acting in the best interests of the company, the proper purposes test was irrelevant.[76] Today, however, it is now firmly established that directors must act in the best interests of the company *and* for a proper purpose.[77] Accordingly, both duties will be examined.

The *bona fide* test has been a harsh example of the difficulties surrounding judicial interpretation. As we have seen,[78] two issues specifically have caused ambiguity, namely the meanings of *bona fide* and the company. We will briefly re-examine both of these in relation to corporate philanthropy. The meaning of the company will be examined first. This issue has considerable significance for the question of corporate donations. If a narrow interpretation is used, then the societally beneficial nature of donations will not fit within a narrow definition.

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[72] S.4 Companies Act 1985. Although as we have seen, the objects clause no longer limits the company s capacity.
[73] As we have seen, many company law theorists actively assert that it is inaccurate to describe the shareholders as owners. On why the ownership argument is no longer accurate, see *supra*. at Ch. 2.
[74] [1942] Ch. 304.
[75] *Ibid.* at p.306.
[76] *Teck Corporation v Millar* (1972) 33 DLR (3d) 288 at 312, *per* Berger J.
[77] *Howard Smith Ltd. v Ampol Petroleum Ltd.* [1974] AC 821.
[78] *Supra.* at Ch. 4.

The *bona fide* duty appears to be something of a paradox. It is a well-established tenet of company law that the directors owe their fiduciary duties to the company as a legal entity.[79] Shareholders and creditors cannot enforce the duty,[80] nor can fellow directors.[81] However, this does not mean that the board must act so as to promote the interests of the entity,[82] even though the duty is *owed* to the entity. A duty to benefit an entity that cannot experience well-being would be irrational.[83] The most accurate statement of the duty appears to be that the corporate entity is a vehicle for benefiting the interests of a specified group or groups. [84] In upholding the legal model of the company, this has come to mean the shareholders. Professor Gower notes:

> Despite the separate personality of the company it is clear that directors are not expected to act on the basis of what is for the economic advantage of the corporate entity, disregarding the interests of the members. [85]

He goes on cite the case of *Greenhalgh v Arderne Cinemas*[86] as authority for this statement:

> the phrase the company as a whole does not mean the company as a commercial entity as distinct from the corporators. [87]

It should be stressed however, that despite a few limited areas,[88] a company owes no fiduciary duty to its members. Rather it is a duty to promote the success of the business venture, *in order* to benefit the members. [89] Accordingly, any donation must benefit the members.

Recently, the definition of the company has undergone a slight modification. In 1980, Lord Diplock held that the interests of the company are not exclusively those

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[79] *Percival v Wright* [1902] 2 Ch. 421; *Re Smith & Fawcett Ltd.* [1942] Ch. 304; *Multinational Gas and Petrochemical Co. Ltd. v Multinational Gas & Petrochemical Services Ltd.* [1983] Ch. 258.

[80] *Multinational Gas and Petrochemical Co. Ltd. v Multinational Gas & Petrochemical Services Ltd.* [1983] Ch. 258; *Brant Investments Ltd. v KeepRite Inc.* (1990) 80 DLR (4th) 161.

[81] *Lee v Chou Wen Hsien* [1984] 1 WLR 1202.

[82] *Cf.* *Re Halt Garage Ltd.* [1982] 3 All ER 1016; *Dawson International PLC v Coats Paton PLC* [1989] BCLC 233.

[83] P.L. Davies and Lord Wedderburn, *The Land of Industrial Democracy* [1977] ILJ 197 at 199.

[84] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.77.

[85] L.C.B. Gower, *Principles of Modern Company Law*, 1992, 5th ed., London: Sweet & Maxwell, p.555.

[86] [1951] Ch. 286.

[87] *Ibid.* at p.291, *per* Evershed MR.

[88] Such as when a company is the target of a takeover (*Heron International Ltd. v Lord Grade* [1983] BCLC 244) or where the company is a quasi-partnership (*Ebrahimi v Westbourne Galleries Ltd. and others* [1973] AC 360.) For more on the possibility of a direct fiduciary duty, see *supra.* at Ch. 4.

[89] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.77.

of shareholders but may also include those of creditors. [90] In following three Australian cases,[91] Nourse LJ, in the leading case in this area held that where a company is both going and solvent, first and foremost come the shareholders Conversely, where the company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of the existing creditors alone. [92]

This extension of the *bona fide* duty to creditors has important implications for the issue of donations. If a liberal approach is to be adopted and corporate donations are to be permitted, then they will only be permissible if the company is financially healthy. If a company is doubtfully solvent, then the directors have a duty to keep the funds inviolate so that if the company becomes insolvent, the creditors will be paid. This reflects a reality of commerce. The practice of corporate philanthropy should be restricted to those companies that have the ability to afford it. Companies in financial difficulty should direct all their efforts towards becoming solvent or, if that is not possible, to ensure that the company will be able to pay it creditors. Accordingly, one could argue that as the company approaches insolvency, the company is actually required to move away from the legal model and act in the interests of its creditors as opposed to its shareholders.

The phrase *bona fide* is also not free from ambiguity. As noted, the dictionary offers two meanings: in good faith and genuine. The distinction is important as the former is a more subjective test whereas the latter is objective in nature. To the regret of many,[93] the court has adopted the former. In Charterbridge Corporation Ltd. v Lloyds Bank Ltd.,[94] Pennycuick J said:

> The proper test I think must be whether an intelligent and honest man *in the position of the director of the company concerned*, could have reasonably believed that the transactions were for the benefit of the company. [95]

This subjective approach goes hand in hand with the tenet that the court will not interfere in the internal management of the company. However, it is not the case that

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[90] *Lonhro Ltd. and Another v Shell Petroleum Co. Ltd. and Another* (1980) 1 WLR 627 at 634.
[91] *Walker v Wimbourne & Others* (1976) 50 AJLR 446; *Nicholson v Permakraft (NZ) Ltd.* [1985] 1 NZLR 242; *Kinsela v Russell Kinsela Pty*. Ltd. (1986) 10 ACLR 395.
[92] *Brady v Brady* [1987] 3 BCC 535 at 552.
[93] *E.g.* L. Sealy, *Bona fides and Proper Purposes in Corporate Decisions* [1989] 15 Mon. L.R. 265 at 269.
[94] [1970] Ch. 62.

in order to exonerate themselves, all the directors need to do is demonstrate subjective honesty. As far back as 1883 Bowen LJ said:

> *Bona fides* cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly *bona fide* yet perfectly irrational. [96]

This has come to be known as the amiable lunatics test. Despite the subjective standard, there is an objective minimum. If the board s decision is one that no reasonable director or shareholder could have reasonably believed was for the benefit of the company, then the court can invalidate it. However, such instances are rare.

The second strand of the duty is the proper purpose doctrine. The weakness of the *bona fide* test, namely its subjective nature, has necessitated that the courts place greater emphasis on this second strand.[97] Directors have considerable power, but their power is limited by the purposes for which that power may be exercised. If directors breach this power and act for an improper purpose, then the court may intervene. Powers given to [directors] for one purpose cannot be used by them for another purpose. To permit such proceedings would be to sanction not the use but the abuse of their powers. [98]

These limits may be derogated by the articles of association.[99] However, in practice, it is difficult to lay down in advance the purposes for which directors may exercise their powers.[100] Therefore, every case must be decided on its own facts.[101]

Despite this, the courts have developed principles with which to determine the proper purpose(s). However, to date, the issue of donations has not been litigated on in this area. Accordingly, the proper purpose doctrine will not be examined any further as any conclusions would be estimations at best.

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[95] *Ibid.* at p.74 (Italics added.)
[96] *Hutton v West Cork Railway Co.* (1883) 23 Ch.D. 654 at 671.
[97] L. Sealy, *Bona Fides and Proper Purposes in Corporate Decisions* [1989] 15 Mon. L.R. 265 at 266.
[98] *Re Cameron s Coalbrook Steam, Coal & Swansea & Lougher Railway Co., Bennett s Case* (1854) 5 De GM & G 284 at 298, *per* Turner LJ.
[99] *Re Smith & Fawcett Ltd.* [1942] Ch. 304 at 306.
[100] In *Howard Smith Ltd. v Ampol Petroleum Ltd.* [1974] AC 821 at 835, Lord Wilberforce stated that [t]o define in advance exact limits beyond which directors must not pass is, in their lordships view, impossible.
[101] *Advance Bank of Australia Ltd. v FAI Insurances Australia Ltd.* (1987) 9 NSWLR 464.

Conclusion.

As can be seen, the lawfulness of acts that depart from the profit goal is not an easy issue to determine. At its most basic level, however, it can be seen that a two-fold test needs to be passed. First, it will need to be determined whether or not the proposed act is *ultra vires*. We have seen that the *ultra vires* doctrine is not hostile to philanthropic acts *per se* provided that they are permitted in the company s objects. Second, it will need to be demonstrated that the act in question does not contravene the director s fiduciary duties. Having examined both of the above tests, it can be seen that the law, in practice, will accommodate a certain degree of departure from the legal model. The conclusion must therefore be that the current limited forms of social activity are permissible under the law and that there is room for companies to engage in more extensive acts of social responsibility before the legal constraints become a serious threat.[102]

CONCLUSION

Many years ago, the US states began to abolish the doctrine of *ultra vires*. This abolition served as a vital catalyst in bringing about the existence of philanthropic statutes and legalizing corporate philanthropy. In 1989, Parliament took the first step towards abolishing this ancient doctrine. However, it was only a step and as we have seen, in certain important respects, the *ultra vires* still survives. Accordingly, the old case law concerning the company s capacity still has a role to play. Instead of bringing clarity to this area of the law, we now have a situation where, depending on the objects of the company and the point in time when the shareholders discovered of the act in question, the transaction may be governed by either pre or post-1989 law. Likewise, the ambiguous wording of s.3A has also failed to bring about any real clarity. Many companies have not used the new objects clause or, if they have, they are used in conjunction with existing objects.

Therefore, the key to the lawfulness of corporate philanthropy can be seen to be the role of the doctrine of *ultra vires*, or at least some statutory recognition of the corporation s right to pursue non-profit goals. Many forms of activity that depart

[102] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1993, Oxford: Clarendon Press, p.280.

from the legal model can in fact be justified on the basis of long-term profit maximisation. This means that it is unlikely that most forms of philanthropy will be in breach of the directors fiduciary duties.

One must therefore conclude that it is indeed permissible for corporations to depart from the parameters of the legal model of the company and engage in activities that are not profit maximising. This means that the company should be free to benefit non-shareholder constituents such an employees and creditors. In the previous chapter, we demonstrated that their interests are certainly worthy of consideration. Provided that there are objects permitting such action, the *ultra vires* doctrine is not hostile to employees or creditors. Given that it appears that the next Companies Act will abolish the *ultra vires* doctrine, there will be no constitutional limitations upon the company s ability to benefit and protect non-shareholder constituents. We saw in Chapter 4 that directors are now permitted to take into account the interests of employees and creditors. Whilst we saw that the duties placed upon the directors to take employee and creditor interests into account are weak, the fact that the directors are able to do so demonstrates an acceptance that it is lawful for companies to act in the interests of such parties.

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Corporate Environmental Responsibility

INTRODUCTION: CORPORATE POLLUTION — A GROWING PROBLEM?

In 1969, the American corporation Union Carbide set up a subsidiary, Union Carbide of India Ltd. (UCIL), to produce pesticides at its Bhopal plant in the State of Madhya Pradesh. One of the ingredients in the production of these pesticides was Methyl Isocyanate (MIC), a highly toxic gas. On the night of 2nd-3rd December 1984, 40 tons of MIC leaked from the plant and drifted eight kilometres downwind over the city of Bhopal. It moved over the poor settlements and onto the more densely populated areas of the city. The original death count was estimated at 2,000.[1] By 1987, the official death toll stood at 3,500 and by 1992, it was over 4,000. However, victim s organisations have placed the death toll at nearer 16,000. Over 400,000 people were seriously injured. A year after the disaster, the Indian Health Minister announced that 36 women had spontaneously aborted, 21 babies were born with deformities and there were 27 stillbirths, all suspected to have been caused by the gas leak. Even today, 10-12 children die every month as a result of illnesses related to the disaster. Despite all of this, Union Carbide still maintains that MIC is merely a mild throat and ear irritant. [2]

The disaster gave rise to the largest lawsuit in history. Three years after the disaster, 487,000 claims had been filed in India under the statutory scheme for the registration and processing of claims set up by the Bhopal Gas Leak Disaster (Processing of Claims) Act 1985. The lawsuit lasted over seven years. Although the final settlement of $470 millions satisfied the Government of India, it was condemned by the victims as being wholly inadequate.[3]

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[1] The figures vary widely. Poor documentation, mass burials and cremations, and conflicting medical opinions ensure that the precise number will never be known.
[2] See *Round the World: India — Long Term Effects of MIC* (1989) 644*Lancet* April 29th p.952.
[3] J. Cassels, *The Uncertain Promise of Law: Lessons from Bhopal*, 1993, Toronto: University of Toronto Press Incorporated, Preface.

Whilst, thankfully, disasters on the scale of Bhopal and Chernobyl are exceptionally rare, they are viewed as typifying what is perceived to be a recurring problem, namely corporate environmental pollution. The number of examples is almost endless. In 1996, Marcropper, a subsidiary of a Canadian mining company operating in the Philippines, released toxic liquid tailings into the surrounding area. The Boac River was so severely polluted as to be declared biologically dead. In the same year, another Canadian mining company, Freeport McMoran Copper & Gold, dumped significant amounts of mine waste in Indonesia leading to substantial local unrest in which two Indonesian tribesman were shot dead and three soldiers injured.

Given the numerous examples of corporate pollution, there is little doubt that the law has found it extremely difficult to regulate corporate environmental activity. The question that must be asked is why have corporations been able to continually cause environmental damage. One notable reason that should be stated at the outset is that in general, corporate law has little to say on the corporation s environmental behaviour; that is left to environmental law and environmental regulation has to date experienced significant difficulties in regulating corporate environmental activity. The corporation has shown itself to being remarkably adept at displacing and avoiding liability under the general environmental law. The first part of this chapter will examine why environmental law has been unable to effectively regulate corporate environmental activity. Part II will examine some specific facets of corporate law that permit the corporation to evade its environmental obligations. Finally, Part III will, based on the theoretical justifications analysed in Chapter 6 and expanded upon in Chapter 7, examine a number of possible theories that could be used to justify greater corporate environmental protection measures from companies themselves.

I. THE INADEQUACY OF ENVIRONMENTAL REGULATION

The History of Environmental Regulation.

Public concerns regarding the environment first arose in the early 1960 s when Rachel Carson s book *Silent Spring*[4] triggered a debate that has gripped the public since.[5]

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[4] R. Carson, *Silent Spring*, 1962, Hammondsworth: Penguin.
[5] Although as T. Cannon, *Corporate Responsibility*, 1992, London: Pitman Publishing, p.188 points out, the Romans saw people crippled and the environment polluted by their early mining methods.

Since then, [t]he evidence that pollution, land degradation, deforestation, ozone depletion, climate change, and the loss of biological diversity are inflicting serious and in some cases irreversible damage to the planet which sustains us, is increasingly compelling. [6] As this evidence has increased, so too have calls for greater environmental regulation. This environmental regulation has evolved in two distinct phases. The first phase began in the early 1970 s when governments around the world responded to increasing pubic concern by enacting a plethora of regulations designed to prevent or minimise environmental degradation.[7] Generally, all over the world, these regulatory approaches followed the United States command and control model of regulation. A command and control approach to regulation basically involves legislatures prescribing certain behavioural standards and setting up regulatory agencies to monitor and enforce compliance of these standards. However, by the late 1970 s, it became apparent that command and control regulation had not been as successful as the legislatures had hoped. Regulatory agencies, notably those in the United States and the UK, adopted an adversarial stance towards those they were regulating which increased regulatory resistance and proved counterproductive.[8] Further, the environmental regulations themselves were often inflexible and prohibitively costly for businesses to comply with.[9] Following these developments, centralized bureaucratic standard-setting — the hallmark of traditional command and control models — has now been subject to continued criticism for being an inherently inefficient and cumbersome way to control pollution [10] and for failing to deliver the environmental benefits that it promised.[11]

However, it has been argued that the critics of command and control regulation have gone too far for a number of reasons. Firstly, whilst the original command and control models of regulation were indeed inflexible and excessively costly, recent

[6] N. Gunningham, *Introduction* in N. Gunningham, P. Grabosky and D. Sinclair, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.3.
[7] On this first phase, see R. Kagan, *Regulatory Enforcement* in D. Rosenbloom & R. Schwartz (eds.), *Handbook of Regulation and Administrative Law*, 1994, Dekker: New York.
[8] See E. Bardach & R. Kagan, *Going By the Book: The Problem of Regulatory Unreasonableness*, 1982, Philadelphia: Temple University Press; D. Vogel, *National Styles of Regulation: Environmental Policy in Great Britain and the United States*, 1986, New York: Cornell University Press.
[9] D.J. Fiorino, *Towards a New System of Environmental Regulation: The Case for an Industry Sector Approach* (1996) 26(2) Environmental Law 457 at 459.
[10] E.D. Elliot, *Environmental TQM: Anatomy of a Pollution Control Program That Works!* (1994) 92 Michigan LR. 1847 at 1849.
[11] *E.g.* see W.E. Orts, *Reflexive Environmental Law* (1995) 89(40) Northwestern University LR. 1227.

models are showing themselves to be much more flexible and cost-effective. Secondly, critics often overlook that the regulatory agencies created to police command and control regulations are often unable to perform the tasks for which they were created due to a lack of resources. Finally, it should not be forgotten that, notwithstanding the aforementioned difficulties, command and control regulation has achieved many significant victories in stopping, or at least slowing, environmental degradation.[12] For example, both water and air quality have been substantially improved in many jurisdictions over the last 30 years, due mostly to governmental regulation.[13]

However, as will be seen later in this chapter, many of these gains have come at an unnecessarily high social and economic cost. In certain areas, command and control regulation has shown itself to be totally ineffective.[14] There is also mounting evidence that the current forms of command and control regulation have reached their limits as regards technical capacity and cost-effectiveness.[15]

It was against the backdrop of this acknowledgement of the shortcomings of command and control regulation that regulatory critics were able to mount a challenge against the traditional command and control model and advocate a policy of environmental deregulation. This began the second phase of environmental regulation. In fact, this campaign for deregulation was so successful that certain areas of environmental regulation that were previously subject to 20 years of governmental regulation, were substantially deregulated during the 1980 s. However, due to public opposition, wholesale environmental deregulation did not take place and, despite resources for environmental regulation being slashed significantly during the Reagan

[12] See G. Easterbrook, *A Moment on the Earth: The Coming of Age of Environmental Optimism*, 1995, New York: Viking Press.
[13] S. Cohen, *EPA: A Qualified Success* in S. Kamieniecki, R. O Brien & M. Clarke (eds.), *Controversies in Environmental Policy*, 1986, Albany: State University of New York Press, p.174.
[14] For example, command and control regulation is poorly equipped to deal with complex environmental problems such as climate change and loss of biological diversity, which demand a far more sophisticated strategy. See A.L. Alm, *A Need for New Approaches: Command and Control is No Longer a Cure-All* (1992) EPA Journal 18.
[15] N. Gunningham, *Introduction* in N. Gunningham, P. Grabosky and D. Sinclair, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.7.

and Thatcher administrations,[16] the regulatory structure and legislation remained largely intact.

Despite this, there is no doubt that the regulators are losing the argument. Proponents of command and control are reluctant to argue for stringent regulation for fear of alienating the business community, who argue that such regulation will make them less competitive and hasten their departure to another jurisdiction.[17] Further, it is now apparent that, even if regulation were to come back into favour, it would probably be unsuccessful. Firstly, the problems of command and control regulation encountered during the first phase of environmental regulation are yet to be resolved, and secondly, governmental resources for environmental regulation are extremely limited. Industrial premises can only be inspected once every few years which means that these inspectors often have to rely on industry to monitor itself. This coupled with the fact that regulatory agencies often do not have the time and resources to initiate prosecutions means that today, the traditional command and control model is perceived as highly limited.[18] However, as we shall see, there is little to indicate that total deregulation would be any better. What is required is a mixture of approaches.

Recognition that what was required was a policy mixture first came in the early 1990 s with the work of Ayres and Braithwaite who argued that what was needed was responsive regulation capable of providing creative options to bridge the abyss between deregulation and pro-regulatory rhetoric. [19] By the mid-1990 s, this dissatisfaction with the regulatory *status quo* led to a number of national and international proposals that contained regulatory mixtures. This first to emerge was Agenda 21, a 1992 sustainable development policy proposed at the Rio Earth Summit, the largest ever gathering of world leaders.[20] Soon to follow was the EU s Fifth Action Program which aimed to create a new interplay between the main groups of

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[16] See J.A. Lash, *A Season of Spoils: The Reagan Administration s Attack on the Environment*, 1984, New York: Pantheon Books.
[17] N. Gunningham, *Introduction* in N. Gunningham, P. Grabosky and D. Sinclair, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.8.
[18] See, for example, N. Gunningham, *Negotiated Non-Compliance: A Case Study of Regulatory Failure* (1987) 9(1) Law and Policy 69.
[19] I. Ayres & J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, 1992, New York: OUP, p.14.

actors (government, enterprise, public) and the principal economic sectors (industry, energy, transport, agriculture and tourism) through the use of an extended, and integrated range of instruments. [21]

However, despite the promising nature of these proposed instruments, little has been done to put them into practice. As the OECD stated in 1997 instruments, while pervasive, are the least analysed [public management tool]. When they are analysed, they tend to be studied individually rather than comparatively. [22] Whilst the United States EPA had, by the mid 1990 s, introduced a number of flexible policy-mixed programmes, they remained ancillary to its other activities and has, to date, only produced marginal results.[23] A similar situation is evident in Europe with heavy reliance on command and control regulation and only limited application of policy mixtures. Over ten years after Agenda 21 was put into action, extinction rates are higher than at any time since the disappearance of the dinosaurs.[24] The Fifth Action Program mentioned earlier was, according to a report in late 1996, making extremely slow progress and was nowhere near completion.[25] Initiatives at a national level have also been disappointing. In the UK, two high level reports in 1997 identified inertia as the dominant governmental response to issues of environmental sustainability.[26]

Forms of Environmental Regulation.

As was noted above, we have moved from a process of regulation towards one of deregulation. However, the deregulation process was only partial and so we are left with an amalgam of various regulatory mechanisms. The various mechanisms used to regulate corporate environmental activity will be examined here. It will be seen that

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[20] United Nations Commission for Environment and Development (UNCED), *Agenda 21: Programme of Action For Sustainable Development, Section 1 Chapter 8(B) Providing an Effective Legal and Regulatory Framework*, 1992, Geneva: UNCED, p.55.
[21] Commission of the European Community (CEC), *Towards Sustainability: Fifth Action Program of the European Union*, 1992, Brussels: CEC, p.25.
[22] PUMA/OECD, *Choices of Policy Instruments*, 20th March 1997, 15th Session of Public Management Committee, Paris: PUMA/OECD.
[23] See T. Davies & J. Mazurek, *Industry Incentives for Environmental Improvement: Evaluation of US Federal Initiatives*, 1996, Washington DC: Resources for the Future.
[24] Figures place extinction rates at over 75 species per day. See T. Juniper, *The Corporate Transition to Sustainable Development* in M.K. Addo (ed.), *Human Rights Standards and the Responsibility of Transnational Corporations*, 1999, Cambridge: Kluwer Law International, p.78.
[25] See H. Joliffe, *European Union Fifth Action Program: Progress Report on Implementation of Towards Sustainability* (1996) 5(4) Review of European Community and Environmental Law 342.

each has unique flaws that have proved almost impossible to overcome. Accordingly, it will become evident that a mixture of the various forms of regulation is required if environmental degradation is to be reduced.

Command and Control Regulation.

As noted, during the first phase of environmental regulation, the primary governmental response to the problem if environmental damage was to apply direct or command and control regulation designed to prohibit or restrict environmental degradation. We will now look at this form of regulation in more detail.

A common feature of command and control regulation is the setting of an environmental target such as a limit on industrial emissions, and the application of a penalty if these targets are not met. In determining these targets, many legal systems, most notably the United States, adopt a best available technology (BAT) or similar technology based standard.[27] This involves setting a standard on the basis of what is technically feasible at the time. The industry in question may also have an impact on the standard set. In the UK, a differing set of standards has been used. Many older statutes use a standard known as the best practical environmental option (BPEO). According to the Royal Commission on Environmental Pollution, BPEO emphasises the protection and conservation of the environment across land, sea and air and establishes for a given set of objectives, the option that provides the most benefit or least damage to the environment as a whole, at an acceptable cost, in the long term as well as the short term. [28] Several statutes then moved to a best practicable means (BPM) standard.[29] However, more recent statutes have employed a differing standard requiring forms to use best available techniques not entailing excessive costs (BATNEEC). Accordingly, the definition of BATNEEC is crucial as to whether the new breeds of environmental legislation will succeed, and it is to this we will now turn.

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[26] See Environmental Data Services Ltd., *Sustainable Development Advisors Take Government to Task* (1997) ENDS Report, Number 264, p.7.

[27] See A.S. Miller, *The Origins and Current Directions of United States Environmental Law and Policy: An Overview* in B. Boer, R. Fowler & N. Gunningham (eds.), *Environmental Outlook: Law and Policy*, 1994, Sydney: Federation Press.

[28] Royal Commission on Environmental Pollution, *Twelfth Report of the Royal Commission on Environmental Policy*, February 1988, Cm.310, pp.11-2.

[29] See for example s.2 Alkali and Works Regulation Act 1906 and s.5 Health and Safety at Work Act 1974.

The first point that needs to be made is that BATNEEC does not prohibit pollution absolutely. Even with the best pollution controls in place, environmental damage might still occur. Accordingly, by balancing the need to minimise harm with the constraints of feasibility and the costs of prevention, the Act is clearly relying on the principle of proportionality, as many other statutes worldwide tend to.[30]

In defining the scope of BATNEEC, the courts have looked back to the case law defining BPM. Unfortunately, BPM was never fully defined, but there are partial definitions. However, there is authority that the term practicable is to be defined more stringently that reasonably practicable. In *Adsett v K and L Steel Founders and Engineers Ltd.*,[31] Parker CJ stated that [i]t seems to me that practicable must impose a stricter standard that reasonably practicable. [32] This was followed in the case of *Moorcroft v Thos Powles & Sons Ltd.*,[33] where Lord Parker, in interpreting the word impracticable stated that it must mean not possible or not feasible. At any rate it means something very much more than not reasonably practicable. [34] So, it would seem to follow that as a matter of language and law, the BPM duty, and most likely the BATNEEC duty, will not invalidate a means simply because it is extremely costly, providing that it is feasible.

It would therefore appear that under such a regulatory standard, a very strict level is required. However, it is now clear that the issue of cost does enter the issue. Irrespective of the strict legal definitions of BPM and BATNEEC, the various pollution Inspectorates have interpreted the term BPM with regard to financial considerations. For example, the annual report of the Chief Inspector for the Alkali and Clean Air Inspectorate states that [i]n deciding whether such costs are practicable in any given circumstances, it is the aim to achieve a reasonable balance between the costs of prevention (or dispersion) on the one hand and the benefits on the other. [35] By tempering the need to ensure BPM with this balance test between

[30] For example, see the US Clean Air Act 1982 which requires emission levels to be set at levels which provide an ample margin of safety.
[31] [1953] 1 All ER 97.
[32] *Ibid.* at p.98H.
[33] [1962] 1 WLR 1447.
[34] *Ibid.* at p.1454.
[35] Health and Safety Executive, *Industrial Air Pollution 1981*, 1982, London: HMSO, para.146.

benefit and cost, it has been contended that this has weakened the regulatory standards.[36] Also, the Inspectorate s intention to take into account local conditions and circumstances raises the worry that the standard will be even lighter where firms operate in areas of high unemployment.

Provided that there is adequate monitoring and enforcement, the main strength of command and control regulation is its clarity. The expected behaviour of regulatees can be specified in advance with considerable clarity (for example, by the setting of national minimum standards), making it relatively easy to identify breaches and punish those in breach.[37] Accordingly, both regulator and regulatee are both aware of their roles leading to greater compliance and enforcement.

There is indeed evidence that this is the case. Command and control regulation has been relatively successful in curbing pollution, outlawing extremely hazardous substances and the dumping of toxic waste and the protection of endangered species. Other benefits include reductions in airborne pollutants such as lead concentrations and ozone depleting substances, and similar successes in water improvements have resulted in a drastic improvement in the quality of our national rivers.[38] One commentator has argued that command and control BAT standards have a number of advantages over more flexible instruments. In particular, he cites:

> decreased information, collection and evaluation costs, greater consistency and predictability of results, greater accessibility of decisions to public scrutiny and participation, increased likelihood that regulations will withstand judicial review, reduced opportunities for manipulative behaviour by agencies in response to political or bureaucratic pressures, reduced opportunities for obstructive behaviour by regulated parties, and decreased likelihood of social dislocation and forum shopping resulting from competitive disadvantages between geographical regions or between firms in regulated industries. [39]

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[36] M. Purdue, *Integrated Pollution Control in the Environmental Protection Act 1990: A Coming of Age of Environmental Law?* (1991) 54 MLR 534 at 543.

[37] O. McGarity, *Four Dimensions of Health and Environmental Regulation*, cited in N. Gunningham, D. Sinclair and P. Grobosky, *Instruments or Environmental Protection* in N. Gunningham, D. Sinclair and P. Grobosky, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.41.

[38] On these successes, see C. Sunstein, *Paradoxes of the Regulatory Scene* (1990) 57 Uni. Chi. LR. 407 and A.W. Reitze, *A Century of Pollution Control Law: What Worked; What s Failed; What Might Work* (1991) 21 Environmental Law 1549.

[39] H. Latin, *Ideal Versus Real Regulatory Efficiency: Implementation of Uniform Standards and Fine Tuning Reforms* (1985) 37 Stan. LR. 1267 at 1271.

Further, it has been argued that stringent command and control regulations can result in technological innovations that aid regulatory compliance and, in doing so, can enhance international competitiveness.[40] For example, in Germany, tough command and control regulations have been credited not only with increased efficiency through technological and managerial improvements, but also the creation of new pollution control industries.[41] These firms can export their products and services to countries that have aspirations of matching Germany s impressive environmental record.

Despite these successes, command and control regulation is better suited to some situations than others. The clear standards that command and control models advocate are better enforced against firms that are readily identifiable and accessible. [42] For example, regulators in the United States enforcing a Federal law that required limited erosion and site remediation at strip mines were far more successful when dealing with larger firms which were easy to identify, visit and monitor when compared to their enforcement record with smaller firms.[43] Command and control regulation has shown itself ineffective in dealing with transitory, mobile firms, is unable to regulate pollution that transfers from one medium to another and cannot keep apace with technological innovations and economic circumstances. Sadly, most of the most severe environmental issues fall into these categories with the result that many of the most pressing environmental concerns, such as deforestation, desertification, agricultural run-off and urban air pollution, have not been alleviated by command and control regulations.[44] Also, command and control regulation is clearly going to have more success regulating the behaviour of large firms because they are so identifiable. However, most environmental damage derives from small and medium sized firms. Although their individual impact may be small, collectively their influence is significant. It has been claimed that small and medium sized firms

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[40] M. Porter, *The Competitive Advantage of Nations*, 1990, London: Macmillan Press.

[41] N. Gunningham, D. Sinclair and P. Grobosky, *Instruments or Environmental Protection* in N. Gunningham, D. Sinclair and P. Grobosky, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.43.

[42] *Ibid.* Kagan refers to the difference between regulating elephants and foxes : it is harder for elephants to hide. See R. Kagan, *Regulatory Enforcement* in D. Rosenbloom & R. Schwartz (eds.), *Handbook of Regulation and Administrative Law*, 1994, New York: Dekker.

[43] N. Shover, D.A. Clelland & J. Lynxwiler, *Enforcement or Negotiation: Constructing a Regulatory Bureaucracy*, 1986, Albany: State University of New York Press.

[44] A.L. Alm, *A Need for New Approaches: Command and Control is No Longer a Cure-All* (1992) EPA Journal 18th May 6

account for around 70% of total environmental pollution in the UK.[45] Even if the regulations in place are effective, compliance needs to be monitored. Unfortunately, resources are insufficient to monitor effectively, especially in the case of small and medium sized firms. Even in relatively well-resourced areas such as workplace safety, it has been stated that small firms can anticipate being inspected once every 80 years and in reality most firms will never be inspected.[46]

Further examination reveals some fundamental weaknesses and contribute to the perception that command and control regulation is of limited effectiveness. One of the most common criticisms is that command and control regulation requires regulators to have a detailed knowledge of the internal workings of the industries in question. For example, as noted earlier, many command and control regulations establish a BAT standard and in order to determine these standards regulators have to engage in lengthy and intricate information gathering exercises in order to set effective and appropriate standards. Given that regulatory agencies often have highly limited funding, such exercises cause a massive drain on their resources. Even if regulators have the requisite funds, there is still a considerable imbalance of knowledge between the regulators and industry. Even if the regulators did strike an appropriate standard, it would only be a temporary solution as technology, population and economic situations change and the environmental provisions will need to change with them.[47]

Uniform command and control regulations also raise efficiency issues. Firms will differ in terms of how much they need to spend in order to comply with pollution reducing regulations. However, uniform standards prevent firms from personalising their solutions to meet the needs of their business, even though some firms may be able to reduce pollution at much lower costs. The net effect of this is to increase the overall cost of regulation.[48] A further efficiency issue is that the onus is on the

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[45] *Small Firms and the Environment: A Groundwork Status Report*, 1998, Birmingham: Groundwork Foundation National Office, p.13.

[46] N. Gunningham, *Regulating Small and Medium Sized Enterprises* (2002) 14 Journal of Environmental Law 3 at 23.

[47] A.L. Alm, *A Need for New Approaches: Command and Control is No Longer a Cure-All* (1992) EPA Journal 18th May 6.

[48] N. Gunningham, D. Sinclair and P. Grobosky, *Instruments or Environmental Protection* in N. Gunningham, D. Sinclair and P. Grobosky, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.44.

regulators to increase pollution reduction by constantly updating BAT standards. The reason for this is that under uniform command and control regulations, there are no incentives for firms to go beyond the minimum standards, especially if the firm has already invested in technology that meets the existing standard.[49] Consequently, the onus is always on the government to apply stricter standards, which again entails an in-depth examination into the industry in question. It has been contended that this inability to encourage firms to go beyond minimum standards is one of the most serious failures of command and control regulation.[50]

These regulatory inefficiencies increase the costs and compound the difficulties faced by the enforcement agencies. Many agencies are committed to enforcement but have insufficient resources to monitor regulatory compliance effectively. Accordingly, the deterrent value that they have is emasculated. However, even where such agencies can pose a viable deterrent threat, such regulatory agencies often face considerable defiance and resistance. Makkai and Braithwaite have found that where a regulatory agency undertook a deterrent role, regulatory compliance actually went down.[51] This resistance is understandable when regulation impedes corporate efficiency and competitiveness. Ultimately, it leads to an adversarial relationship between regulator and regulatee which jeopardises efficiency further.

Finally, command and control regulations are vulnerable to political manipulation. There are several recent examples where regulatory policy has been strongly influenced by groups with political influence who aim to serve their own agendas at the expense of improved environmental policy.[52]

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[49] C. Sunstein, *Paradoxes of the Regulatory Scene* (1990) 57 Uni. Chi. LR. 407.
[50] This is certainly the case in the US and UK. However, compare this with the position in Germany where the law requires BAT standards to be drafted in such a way as to give incentives to companies that implement cutting-edge technologies that go beyond the minimum requirements. See S. Breyer, *Breaking the Vicious Circle: Toward Effective Risk Regulation*, 1993, Cambridge: Harvard University Press and J. Bernstein, *Alternative Approaches to Pollution Control and Waste Management – Regulatory and Economic Instruments*, 1993, Washington DC: The World Bank.
[51] J. Braithwaite & T. Makkai, *Trust and Compliance* (1994) 4 Policing and Society 1.
[52] See R. Leone, *Who Profits? Winners, Losers and Government Regulation*, 1986, New York: Basic Books and B.A. Ackerman & W.T. Hassler, *Clean Coal/Dirty Air or How the Clean Air Act Became a Multibillion-Dollar-Bail-Out for High-Sulfur Coal Producers and What Should Be Done About It*, 1981, New Haven: Yale University Press.

Given these weaknesses of command and control regulation, a number of commentators have argued that this form of regulation has reached the limits of its effectiveness.[53] However, legislatures worldwide have also recognised that command and control regulation has several flaws and, in recent years, have developed a number of new innovations that aim to avoid some of the weaknesses discussed previously.

We noted that one significant weakness of command and control regulation is that it creates an adversarial atmosphere between industry and the regulators. One notable initiative that has succeeded in reducing this weakness is the United States Yorktown Project, a joint enterprise between the EPA and the Amoco Corporation. By cooperating, these parties were able to identify the ways in which command and control regulation failed to encourage or reward innovation. They then showed that by permitting each firm to tailor its compliance strategy rather than the one-fits-all approach was far more cost effective and encouraged greater innovation. Accordingly, the various participants selected the most effective pollution options available given their specialised industries, often these solutions being vastly differing to those prescribed by the regulations. The result was that by prioritising projects in this manner, equivalent release reductions could have been achieved at 25% of the cost.[54]

As well as the Yorktown Project, the Clinton administration adopted several other innovations in line with the aims of the Reinvesting Environmental Law initiative.[55] The first of these was Project XL, a project designed to reward companies that have developed creative, common sense ways of achieving superior environmental performance at their facilities.[56] This initiative attempts to avoid the broad brush approach of traditional command and control models by allowing companies to

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[53] D.J. Fiorino, *Towards a New System of Environmental Regulation: The Case for an Industry Sector Approach* (1996) 26(2) Environmental Law 457; A. Moran, *Tools of Environmental Policy: Market Instruments Versus Command and Control* in R. Eckersley (ed.), *Markets, the State and the Environment*, 1995, Melbourne: Macmillan Press, p.73 and W.E. Orts, *Reflexive Environmental Law* (1995) 89 Northwestern University LR. 1227.

[54] B.J. Raffle & D. Mitchell, *Effective Environmental Strategies: Opportunities for Innovation and Flexibility Under Federal Environmental Laws*, 1993, Chicago: Executive Summary, Amoco, p.1.

[55] On this, see W.J. Clinton & A. Gore Jnr., *Reinventing Environmental Regulation*, 1995, Washington DC: The White House.

[56] *Ibid.* at p.36.

propose alternative environmental strategies where the company can demonstrate that such strategies will achieve better environmental results than expected to be achieved under existing law. [57] Another notable initiative, created by the EPA, is the Sustainable Industry Project, which aims to develop policies that foster permanent integration of environmental protection functions into the basic profit-orientated activities of industrial firms. [58] As we shall see this is a noteworthy development as it is often the incompatibility between profit maximisation and environmental regulation that leads many corporations to disobey the regulations.

The US is not the only country to adopt new innovations in environmental policy. The Victorian EPA in Australia, under its accredited licensing scheme, also aims to move away from the inflexible command and control regulations and permit facility-specific environmental policies. Those firms that succeed in their goals of reducing pollution will be rewarded by being relieved of certain regulatory burdens such as works approvals or licensing requirements.[59] In order to participate, firms must have an exemplary environmental record, they must conduct periodic environmental reviews and implement an environmental management system. The aim of the accredited licensing scheme is to avoid one of the key weaknesses of traditional command and control models, namely to provide an incentive to go beyond mere compliance with existing regulations.

The regulators in Denmark have gone one step further by negotiating pollution reduction targets with industry that go well into the middle of this century.[60] These targets go well beyond the requirements of current command and control regulations. Here in the UK, there is also evidence that a more flexible approach designed to reward good environmental behaviour is emerging with the advent of the integrated pollution control concept.[61]

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[57] *Ibid.*
[58] US EPA, *Sustainable Industry: Promoting Strategic Environmental Protection in the Industrial Sector: Phase 1 Report*, 1994, Washington DC: US EPA, p.1.
[59] A.T. Iles, *Adaptive Management: Making Environmental Law and Policy More Dynamic, Experimentalist and Learning* (1996) 13(4) Environmental and Planning Law Journal 288 at 299.
[60] See R. Gerits & J. Hinssen, *Environmental Covenant for the Oil and Gas Producing Industry: A Valuable Policy Instrument* (1994) 24(6) Environmental Policy and Law 323.
[61] However, this concept encountered numerous problems in its early stages and has, to date, not been successful. See K. Allott, *Integrated Pollution Control: The First Three Years*, 1994, London: Environmental Data Services.

However, it should be noted that, despite their potential, these innovations are still in their infancy and their effectiveness will not be known for a number of years. However, already concerns are being expressed that these initiatives focus too strongly on large firms and that the administrative requirements of these initiatives will prove too costly for many smaller firms. Further, there is a danger that setting standards for the future (as has been done with the Dutch covenants) will result in a serious miscalculation or technological change.[62]

Self-Regulation.

Self-regulation has started to play an increasingly important role in corporate governance issues in the UK. However, its contribution is often overlooked in relation to environmental regulation. With the growing recognition of the weaknesses of command and control models, it appears that self-regulation is beginning to play an important role as an alternative, or as a compliment, to, governmental regulation.

Self-regulation can be defined as a process whereby a recognised industry group regulates the behaviour of its members.[63] Self-regulation can further be defined in terms of the degree of governmental intervention (due to the fact that absolute self-regulation with no governmental involvement is rare.)[64] However one defines self-regulation, the point to be noted is that recently, a number of sophisticated self-regulatory schemes have been developed in the area of environmental regulation. These include increased safety measures introduced by the Institute of Nuclear Power Producers (INPO) in the US,[65] encouraging sustainability under the Brazilian

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[62] N. Gunningham, D. Sinclair and P. Grobosky, *Instruments or Environmental Protection* in N. Gunningham, D. Sinclair and P. Grobosky, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.50.

[63] Organisation for Economic Co-operation and Development, *Meeting on Alternatives to Traditional Regulation*, 1994, Paris: OECD, p.7.

[64] See, for example, the three forms of self-regulation found in J.V. Rees, *Reforming the Workplace: A Study of Self-Regulation in Occupational Health and Safety*, 1988, University of Pennsylvania Press, p.9.

[65] See J.V. Rees, *Hostages of Each Other: The Transformation of Nuclear Safety Since Three Mile Island*, 1994, Chicago: University of Chicago Press. INPO is a private regulatory body with about 400 employees that develops standards, monitors companies and investigates accidents. With an annual budget of about US$54 millions, INPO has been responsible for significant improvements within the industry.

Extractive Reserves system,[66] and the Canadian forest industry s Sustainable Forest Management Certification System.[67]

However, one scheme in particular, due to its ambition and scope, deserves particular mention, namely the chemical industry s Responsible Care programme. However, before examining the details of this scheme, some background information on the chemical industry will be of aid. It will also demonstrate why traditional command and control models have shown themselves to be insufficient.

The late 1980 s witnessed a significant expansion in the chemical industry. During that period, world chemical gross output grew from US$744 billions to US$1.136 trillions.[68] In the US, the chemical industry is the second largest manufacturing industry with some 1.1 million employees and over $316 billions in sales. It is also a leading industry in Europe where it accounts for 37% of the total European manufacturing balance.

Just as the chemical industry is a major source of world income, so too is it major source of world pollution. It is the United States largest generator of toxic chemicals, releasing about 20 billion pounds of toxic chemicals into the environment.[69] Roughly half of all releases reported under the EPA s Toxic Release Inventory and 80-90% of hazardous waste generation reported through the Resource Conservation and Recovery Act, are attributed to the industry.[70] Similar information in Europe is lacking, but evidence indicates that the pattern is similar.[71] There are also significant public outcries over the risks of accidents and explosions in chemical factories.

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[66] See Environmental Law Institute (ELI), *Brazil s Extractive Reserves*, 1996, Washington DC: ELI, Ch.V.

[67] See G.T. Rhone, *Canadian Standards Association Sustainable Forest Management Certification System*, 1996, Ottawa: Industry Canada.

[68] International Labour Organisation, Chemical Industries Committee, *Recent Developments in the Chemical Industry*, 1995, Geneva: ILO, p.10.

[69] R. Gottlieb (ed.), *Reducing Toxics: A New Approach to Policy and Industrial Decision Making*, 1995, Washington DC: Island Press, p.210.

[70] US EPA, *Toxic Release Inventory*, 1993, Washington DC: EPA, p.60. These figures were three times greater than the next highest polluter, the metal industry.

[71] For example, see International Labour Organisation, Chemical Industries Committee, *Recent Developments in the Chemical Industry*, 1995, Geneva: ILO, p.34.

Responding to the public condemnation following the above, the chemical industry has made concerted efforts over the last decade to improve its environmental record. Since 1987, the US chemical industry claims to have reduced releases of toxic emissions by 49%.[72] A CMA survey of its member companies found that releases had been reduced by 16%, underground injection by 14% and transfers by 21%.[73] The cost of these reductions has not been low — the industry estimates it at $22 billions since 1973.[74] In 1993 alone, pollution abatement spending was over US$4.4 billions rising to US$6 billions in 2000.[75] European chemical companies have responded similarly. In the UK, capital spending on environmental protection has risen from 8% in 1990 to 14% in 1992.[76] Australian chemical companies have also increased expenditure.

One reason why the chemical industry has been able to pollute the environment so freely is that in most developed countries, the chemical industry has been regulated entirely by the various forms of command and control regulation. Accordingly, the criticisms aimed at command and control models mentioned earlier are directly applicable to regulation of the chemical industry. Accordingly, a new form of regulation had to be adopted. This need led to the adoption of the Responsible Care programme which now operates in 41 countries and reaches around 88% of the global chemical industry. The programme has been described as the most ambitious and comprehensive environmental, health and safety improvement effort ever attempted by an industry, [77] and as an outstanding model for voluntary industry efforts to promote chemical risk management and compliment environment, health and safety regulatory processes. [78]

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[72] See Chemical Manufacturers Association (CMA), *Fact Sheet: Chemical Industry Halves Toxic Releases*, 1996, Washington DC: CMA.
[73] Chemical Manufacturers Association, *The Year in Review, 1996-97*, 1997 *Responsible Care Progress Report*, Washington DC: CMA, pp.5-7.
[74] Chemical Manufacturers Association, *US Chemical Industry Statistical Handbook 1995*, 1995, Washington DC: CMA, p.107.
[75] L. Ember, *Overhaul of Environmental Law Needed for Sustainable Development* (1993) March 15th *Chemical and Engineering News*, p.17.
[76] European Chemical Industry Council (CEFIC) [Online] Available http://www.innet.net/cefic/cgi-bin November 1996.
[77] J.R. Hirl, *Don t Trust Us. Track Us* (1992) UN 242 No. 21 (17th December).
[78] International Council of Chemical Associations Global Status Report on Responsible Care. *ICCA Readies Itself for Ottawa Meeting* (1996) 5 Careline 1.

The Responsible Care programme itself is relatively simple. Chemical companies commit themselves to improving all aspects of their business that relates to health and the environment. This will be achieved in two-steps. The first step is the establishment of a number of Codes of Practice that aim to reflect industry best practice. These are intended to become the rules (in addition to the prevailing legislation) by which member companies operate. Adoption of these rules and compliance with them is a condition of council membership. [79] According to the ACIC, these Codes would be sensitive to community concerns, provide information on possible hazards, encourage community involvement in emergency response planning and establish a regular process of positive communication. [80] The second step is a commitment to establish community participation and consultation mechanisms. In Australia, this is achieved through the National Community Advisory Panel (NCAP), in the US by the National Public Advisory Panel and in Canada by a National Advisory Panel.[81] For example, the Australian NCAP comprises of a cross-section of individual community thought leaders with particular concerns for environmental safety and health issues. [82] NCAP provides a vehicle through which the community may help shape the Responsible care programme.

As has been noted and will be seen later, most forms of regulation can only achieve their full potential if the interests of the regulators and regulates coincide. It has been contended that the chemical industry is one area where such a scenario exists. The reason for this is that the chemical industry is dominated by large multinational corporations who have both the motivation and the ability to implement the changes that the Responsible Care programme envisages. The motivation comes from the decreasing reputation of the industry following a series of public accidents such as Bhopal mentioned earlier. Traditionally, firms have tried to disassociate themselves from the accident in question. However, as chemical accidents tend to be highly visible and easily attributed to an individual corporation, this strategy has become increasingly difficult. Accordingly, large chemical companies have found that the only way to improve their image is to improve their environmental record. As one

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[79] Australian Chemical Industry Council (ACIC), *Annual Report*, 1993, Melbourne: ACIC, p.2.
[80] *Ibid.* at p.3.
[81] It should be noted that, to date, these three countries are the only ones to have well-established public advisory bodies in place.
[82] Australian Chemical Industry Council (ACIC), *Annual Report*, 1993, Melbourne: ACIC, p.3.

senior executive stated, the chemical companies just [could not] advertise their way out of it. [83]

Initially, the task of improving the industry s reputation was left to the initiatives put in place by individual companies and there is evidence to suggest that many companies put such initiatives into place.[84] However, individual initiatives soon proved insufficient to improve the reputation of the industry as a whole. As one industry spokesman stated Du Pont and other majors can t rest on their accomplishments. They need to recognise than any incident in the industry destroys the credibility of everyone. [85] The Canadian Chemical Producers Association President Jean Belanger noted in 1991 that if a paint company or a plating company does something wrong the headlines the next day will scream that chemicals have been wrongly handled and so we will all be tarred by the same brush. [86] The practical effect of this is that each company must monitor its competitors. Large companies know that the best way to achieve this is by using the Responsible Care programme. The question is will it be successful.

Potentially, the answer is yes. [T]he various Responsible Care mechanisms designed to develop mutual trust among competitors; to facilitate mutual aid, information and technology sharing, peer support, and pressure; for corporate shaming; and dialogue with local communities, the public and governments, create a climate which can motivate and drive corporate executives to do far more in terms of environmental performance than the law could credibly require. [87]

However, despite this considerable potential, there are also numerous problems. Again, like all other forms of regulation, self-regulation works better in some areas than it does in others. Notably, the Responsible Care programme suffers from the traditional conflict between environmental protection and profit maximisation. In

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[83] An interview with C. Greenert quoted in *Responsible Care* (1991) Harvard Business School Documents 9-391-135, 1-26.
[84] For examples, see Chemical Manufacturers Association (CMA), *Annual Reports for 1996 and 1997*, 1997, Washington D.C.: CMA.
[85] Quoted in N. Gunningham, *The Chemical Industry* in N. Gunningham, P. Grabosky & D. Sinclair, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.161.
[86] *Ibid.*
[87] *Ibid.* at pp.163-4.

particular, the market pressures that drive some companies to short-term profitability are not compatible with the aims of the Responsible Care programme. It is clear that those firms that are economically marginal will be unable to afford the luxury of a long-term view.[88] Such firms are highly likely to sacrifice environmental concerns for short-term profitability. Further, these firms will probably be heavily reliant on old, inefficient plant and machinery that emit the highest levels of pollution. To refit such a plant would be far too expensive for such firms and so environmental concerns are subordinated.[89]

In contrast, companies with high profit margins and advanced technology will be in a far better position to adopt strategies that yield long-term benefits. Accordingly, they can adopt long-term strategies that can align the disparity between environmental protection and profit maximisation.

Accordingly, the motivation to implement the Responsible Care programme will be far less for small companies than it will be for larger companies. For large companies with a high public profile, the consequences of a poor environmental record will be both substantial and visible, thereby making environmental improvements a high priority. Such firms will have the ability to make such improvements. Conversely, many smaller companies do not have a public presence and therefore, their business will be far less affected by a poor environmental record. Their capacity to remedy environmental problems is also often very limited. Evidence for this came when the Australian Chemical Specialty Manufacturers Association, a body that represents small and medium sized chemical companies, withdrew completely from the Responsible Care programme, citing the excessive costs and burdens that the programme imposed upon its members.

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[88] President s Council on Sustainable Development, Eco-Efficiency Task Force, *Chemical Operations Demonstration Project*, 1995, Washington DC, p.22.

[89] As one commentator stated [v]oluntary actions are likely to be viewed as dispensable extravagances by companies suffering financial difficulties. They may be abandoned over time as management changes or pressure for such effort fades. See R. Abrams & D.H. Ward, *Prospects for Safer Communities: Emergency Response, Community Right to Know, and Prevention of Chemical Accidents* (1990) 14 Harvard Environmental Law Review 135 at 188.

This disparity also results in a problem that frequently arises, namely the free-rider problem.[90] Given the above, many smaller companies, if not properly regulated, will continue to inflict significant harm on the environment, which will seriously emasculate the effectiveness of, if not totally defeat, the Responsible Care programme. If the majority of smaller companies do not comply, then the larger companies lose much of their incentive to comply, for, as we have seen, they will be tarred with the same brush and the industry as a whole will be criticised. Environmentally friendly companies will suffer the same criticism and stigma that the non-complying companies suffer. Accordingly, complying companies may be putting themselves at a disadvantage to their more pragmatic rivals, who will increase their profits through non-compliance whilst gaining all the benefits by free-riding off the efforts of complying companies.

A further problem of the Responsible Care programme, which is also a problem akin to most self-regulatory schemes, is the issue of how to punish those who refuse to comply. If moral pressure from peers is ineffective, then in cases where members clearly disregard their obligations in respect of Responsible Care and government expectations, their membership can be terminated. [91] However, the expectations of this occurring are very low. For example, in North America, where Responsible Care has been operational for a number of years, there have been no expulsions. This appears to reflect the philosophy of the various regulatory bodies. As a senior member of the UK Chemical Industry Association (CIA) has stated [y]ou can t get acceptance just by jamming things down people s throats. [92] In 1996, Denmark became the first Responsible care participant to expel a member for poor environmental performance.[93] However, even expulsion may not be punitive enough. Many chemical industry associations will not disclose the identity of firms that withdraw from the Responsible Care programme, thereby reducing the public shaming element of the scheme.

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[90] We have already discussed this problem in relation to institutional investors. See *supra*. at Ch. 5. On the free-rider problem generally, see M. Olson, *The Logic of Collective Action*, 1965, Cambridge: Harvard University Press.

[91] Australian Chemical Industry Council (ACIC), *Responsible Care Program Guide*, 1990, Melbourne: ACIC, p.20.

[92] T. Posner (1992) 5 *The Engineer* 20 at 20.

[93] The former member is now suing the Industry Association for doing so.

The final and perhaps most emasculating weakness of the Responsible Care programme is its lack of accountability. The industry as a whole now has such a tarnished reputation that no self-regulatory scheme may be effective. As one commentator as noted:

> The chemical industry is long past the time when it can say we re doing x, y and z, and have people take its word for it While there is certainly more accountability in Responsible Care than in other industry programs, there is still not enough teeth in it. [94]

The simple fact is that whilst industry is responsible for monitoring its own conduct, there will always be a temptation to exaggerate the extent of its accomplishments. This is why ultimately, many critics believe that the Responsible Care programme will be unable to overcome the public trust problems identified earlier.

In fact, in relation to environmental issues, self-regulation has acquired a tarnished image. Many conservationists and consumer organisations view self-regulation as a cynical attempt by industry to give the appearance of regulation whilst serving the interests of the parties concerned. As one commentator has noted:

> Self-regulation is frequently an attempt to deceive the public into believing in the responsibility of an irresponsible industry. Sometimes it is a strategy to give the government an excuse for not doing its job. [95]

These critics argue that self-regulation lacks the virtues of command and control regulation in terms of visibility, credibility, accountability, compulsory application to all, greater likelihood of rigorous standards being developed, cost spreading, and availability of a range of sanctions. [96]

Accordingly, whilst self-regulation can offer much, it has considerable limits. And when these limits arise, we must again rely on the traditional command and control models. This may explain why many commentators prefer traditional command and control models to recent self-regulatory ones.[97]

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[94] Peter Sandman quoted in D. Rotman, *Pushing Pollution Prevention* (1991) *Chemical Week* 17[th] July 30 at 33.
[95] J. Braithwaite, *Responsive Business Regulatory Institutions* in C. Cody & C. Sampford (eds.), *Business, Ethics and Law*, 1993, Sydney: Federation Press, p.91.
[96] K. Webb & A. Morrison, *The Legal Aspects of Voluntary Codes* in D. Cohen & K. Webb (eds.), *Exploring Voluntary Codes in the Marketplace*, 1998, Ottawa: Government of Canada, p.1.
[97] As one government regulatory official noted [i]f self-regulation worked, Moses would have come down from the Mountains with the Ten Guidelines. Quoted in P. Grabosky & J. Braithwaite, *Of*

Voluntarism.

Voluntarism is similar to self-regulation. Under self-regulation, industries coalesce to regulate their firms activities, whereas voluntarism is based on individual firms unilaterally deciding to act in an environmentally friendly manner without any industry coercion. This usually takes the form of voluntary agreements between governments and individual businesses or non-mandatory[98] contracts between equal partners, one of which is government, in which incentives for action arise from mutual interests rather than from sanctions. [99]

There are many examples of voluntary schemes such as this. Amongst the most numerous are schemes involving landholders where, in return for financial support, landholders agree to refrain from an act that could potentially harm the environment. However, not all initiatives of this kind rely on financial inducements. In Australia, for example, many states have programmes in place designed to protect local wildlife. Some of these programmes carry no financial inducements at all. The same is true of the Australian Landcare programme, an initiative designed to reduce land degradation. Some voluntary schemes reward participants not with financial awards, but with an increased public recognition. For example, the United States EPA s 33/50 programme encourages firms to reduce the release of toxic substances by positive public recognition.[100] Participation is completely voluntary and there is no enforcement by law. Instead the programme relies on co-operation between industry and the EPA and the only incentive to participate is the possibility that the firm s reputation could improve. Initial evaluations of the scheme have shown that participating firms have significantly reduced toxic emissions.[101]

Manners Gentle, Enforcement Strategies of Australian Business Regulatory Agencies, 1986, Melbourne: OUP, p.184.

[98] The use of the phrase non-mandatory is crucial for if there was some element of coercion, then they might be regarded as some form of command and control regulation.

[99] OECD, *Meeting on Alternatives to Traditional Regulation*, 1994, Paris: OECD, p.7.

[100] On this, see A.S. Miller, *The Origins and Current Directions of United States Environmental Law and Policy: An Overview* in B. Boer, R. Fowler & N. Gunningham (eds.), *Environmental Outlook: Law and Policy*, 1994, Sydney: Federation Press.

[101] S. Arora & T.N. Cason, *An Experiment in Voluntary Environmental Regulation: Participation in EPA s 33/50 Programme* (1995) 28(3) Journal of Environmental Economics and Management 271. Another successful programme introduced by the EPA is the Green Lights programme whereby firms agree in writing to install energy efficient lighting. In less than three years, the programme signed up over 5% of all commercial office space and is showing investment returns of 20-40%.

Voluntarism has several significant advantages over command and control regulation. Most notably, its non-interventionist approach is likely to result in high industry acceptability and minimal equity concerns.[102] However, like self-regulation, it is likely to work better in some areas than in others. It will be most successful where regulatees perceive that it is in their self-interest to be environmentally friendly.

Sadly, however, this is not often the case. Usually, there is a significant gap between the public desires for environmental protection and the interests of landholders in relation to biodiversity conservation and land improvements. The problem lies in the fact that private landholders usually have no financial incentive to take account of the social costs of their actions. This is a classic example of a negative externality. The direct benefits of biodiversity loss (*e.g.* increased agricultural production resulting from the clearing of land) go directly to individual landholders whereas the costs (*e.g.* loss of species, ecosystems and genetic resources) are borne by society at large. There is also a free rider problem in that the impact of one landholder clearing their land will make little impact on the overall problem, nor will their decision influence the behaviour of other landholders. Therefore, each landholder will have an incentive to take advantage of the willingness of others to protect the environment whilst damaging it themselves.

The challenge that voluntarism faces is how to build mechanisms that strengthen, rather than emasculate, an environmental custodian ethic. Environmental protection must be put on a par with profit maximisation. If this can be done, then voluntary agreements can prove extremely effective because:

> they avoid adversarial relations; involve business or other groups in political processes; improve compliance because rules rest on consensus rather than coercion; and permit, through negotiation, the development of instruments better adapted to economic and competitive contexts. [103]

However, at the moment, we are far from achieving these aims. Currently, profit maximisation and environmental protection are often viewed as mutually exclusive

[102] N. Gunningham, D. Sinclair and P. Grobosky, *Instruments or Environmental Protection* in N. Gunningham, D. Sinclair and P. Grobosky, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.58.
[103] OECD, *Meeting on Alternatives to Traditional Regulation*, 1994, Paris: OECD, p.7.

aims and until this can be changed, voluntarism will never be able to achieve its full potential.

Education and Information Instruments.

The variety of instruments of this type is broad and varied. However, they can be classified into the following categories:[104]

(i) education and training;
(ii) corporate environmental reporting;
(iii) community right-to-know and pollution inventories;
(iv) product certification, and;
(v) award schemes.

(i) Education and Training.

As noted, one reason why other methods of regulation have failed to achieve their full potential is because the attitude amongst many corporations is that profit maximisation and environmental protection are mutually exclusive aims and as profit maximisation is the more important aim, environmental protection is often ignored. One commentator has noted that most firms, particularly small and medium sized firms do not possess the knowledge, skills or solutions necessary to allow them to fully integrate the environment into their business practices. [105] In order for environmental degradation to stop, this needs to change. This is where education and training become crucial. They are critical for changing attitudes and behaviour so that the various initiatives can work. Accordingly, it is apparent that they are not *per se* a form of regulation. Rather they are supplementary to the more traditional forms of regulation, enabling those forms to operate more effectively.

There is considerable evidence that schemes of this kind can improve environmental protection. However, like self-regulation and voluntarism, they work best where their agendas coincide with their targeted participants. One commentator has demonstrated this with the following examples:

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[104] These categories are taken from N. Gunningham, D. Sinclair and P. Grobosky, *Instruments or Environmental Protection* in N. Gunningham, D. Sinclair and P. Grobosky, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.60.
[105] F. Tilley, *The Gap Between Environmental Attitude and Environmental Behaviour of Small Firms* (1999) 8 Business Strategy and the Environment 238 at 245.

> where informed resource users have a self-interest in protecting biodiversity, then educational programmes, appropriately designed, can bring about very substantial benefits. If, for example, eutrophication of a lake is due to farmers using more fertilizer than is necessary to maximize profits, it may only be necessary to bring this to their attention. Enlightened self-interest may then be sufficient to solve, or at least reduce, the problem. Education and information provision can assist to improve management of common-property resources such as a fishery. Fishers may learn that the continued use of a certain type of net will reduce stocks to such an extent that they would lose their livelihoods. [106]

The critical factor in the success of these programmes is whether or not that can effectively target and deliver their message to the intended parties. This may require some innovative approaches. For example, in Australia, it was determined that the most effective way to target and educate users of ozone depleting substances in commercial refrigerators was to train and certify private contractors who serviced such refrigerators.[107] The benefits of this approach were not only improved environmental practices on the part of the contractors but also the delivery of reliable information to otherwise unreachable small and medium-sized businesses. Another method of targeting is to provide toll-free help-lines. This approach has been adopted by the DTI with its Environmental Enquiry Point; a service which provides technical help to companies who wish to improve their environmental records.

(ii) Corporate Environmental Reporting.

Although a relatively new development, there is evidence indicating that corporate environmental reports are becoming a useful internal diagnostic tool that can be used to enhance a firm s environmental record. Already a number of new developments are starting to appear including the use of eco-balance sheets and environmental accounting which measures all business inputs and outputs and calculates environmental efficiency per unit of production.[108] However, before these reports can achieve their full potential, a number of flaws need to be ironed out, namely the reports need to be consistent and need to be independently verified.

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[106] N. Gunningham, D. Sinclair and P. Grobosky, *Instruments or Environmental Protection* in N. Gunningham, D. Sinclair and P. Grobosky, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.60.

[107] See Australia and New Zealand Environment and Conservation Council, *Revised Strategy for Ozone Protection in Australia: Report No. 30*, 1994, Canberra: AGPS.

[108] On this, see C. Jaseh, *Environmental Information Systems in Austria* (1993) 13(2) Social and Environmental Accounting 7.

(iii) Community Right-To-Know and Pollution Inventories.

We have already noted that in order for effective regulation to occur, informational asymmetries need to be reduced. The same is true of environmental regulation. Accordingly, a number of countries have introduced laws requiring the disclosure of pollution and other hazardous activities. Such legislation is commonly referred to as community right-to-know (CRTK) and is designed to inform the public of a firm s environmental record and any environmental policies in place. The central feature of CRTK legislation is the pollution inventory which compiles data on the emission of pollutants or chemicals to the air, water and land. [109] Its function is to document the release or transfer of selected chemical pollutants to all media as a basis for developing and monitoring the effectiveness of pollution prevention measures of programs. [110] In the US, this inventory has been hailed as by the former administrator of the EPA as one of the most effective instruments available [111] for reducing toxic emissions.

The most famous piece of CRTK legislation is the Emergency Planning and Community Right to Know Act (EPCRA) 1986.[112] More recently Canada has followed suit and introduced a national pollution inventory modelled closely on the EPCRA. Many European countries, including the UK, have also introduced similar laws.

The US experience with CRTK has demonstrated this it can have significant benefits, namely it can provide communities with much needed information, highlight the shortcomings of regulatory agencies and create an impetus for stricter control, create an incentive for companies to reduce emissions by sensitising them to community

[109] N. Gunningham, D. Sinclair and P. Grobosky, *Instruments or Environmental Protection* in N. Gunningham, D. Sinclair and P. Grobosky, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.64.
[110] Pollutant Release Transfer Register, p.2 quoted in N. Gunningham, D. Sinclair and P. Grobosky, *Instruments or Environmental Protection* in N. Gunningham, D. Sinclair and P. Grobosky, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.64.
[111] W. Reilly, *Aiming Before We Shoot: The Quiet Revolution in Environmental Policy* (1990) Address to the National Press Club, Washington DC, September 26th.
[112] Emergency Planning and Community Right to Know Act 1986, 42 USC *et seq*. Public Law 99-499. The first piece of CRTK legislation was introduced in New Jersey in 1983.

pressure and can even influence the price of the firm s stock thereby rewarding the good and punishing the bad.[113]

However, like the other forms of regulation, CRTK also suffers from some considerable weaknesses. Firms often fear that disclosure will allow competitors to gain an unfair advantage, or that the information they disclose will be sensationalized by public interest groups. Another problem is the tendency to focus on toxic hot spots at the expense of more widely dispersed pollutants.[114] CRTK legislation relies on local communities using the available information to put pressure on companies to improve their environmental operations. When there is no immediate threat or where there is no identifiable local community, then CRTK legislation has far less success. For these reasons, CRTK, like self-regulation and voluntarism, can only be viewed as a supporting form of regulation.

(iv) Product Certification.

Increasingly, consumers are taking into account a company s environmental record when deciding which products and services to purchase.[115] However, as we noted in Chapter 6, the market is not particularly reliable in providing consumers with accurate information about a company s environmental record. Accordingly, in order to inform consumers of the environmentally friendly nature (or otherwise) of various products, governments can introduce labelling standards and eco-labelling schemes.

In practice, the success of eco-labelling schemes has been sporadic at best due to a number of inherent difficulties. Assessing the environmental impact of various competing products is an extremely difficult task.[116] Many schemes of this nature, with the exception of Germany s Blue Angel scheme, have run into strong industry opposition. Further, eco-labelling schemes can often entail considerable costs, especially if the labelling envisages a full life-cycle analysis of the product. Several

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[113] J.T. Hamilton, *Pollution as News: Media and Stock Market Reactions to the Capitol Toxic Release Inventory Data* (1995) 27(1) Journal of Environmental Economics and Management 98.
[114] N. Gunningham, D. Sinclair and P. Grobosky, *Instruments or Environmental Protection* in N. Gunningham, D. Sinclair and P. Grobosky, *Smart Regulation: Designing Environmental Policy*, 1998, Oxford: Clarendon Press, p.64.
[115] S. Dawson & N. Gunningham, *The More Dolphins There Are the Less I Trust What They re Saying: Can Green Labelling Work?* (1996) 18(1) Adelaide LR. 1.

schemes that were supposed to be self-financing eventually required governmental assistance.[117] For these reasons, a number of governments have withdrawn from the eco-labelling schemes.

(v) Award Schemes.

Award schemes, like product certification schemes, aim to contribute to the education of consumers. When companies act in an environmentally friendly manner, they are awarded. The publicity that accompanies an award has a number of beneficial effects. The company will benefit from the good publicity that, where it not for the schemes existence, may never have become known to the public. This publicity will have an educative function, serving to raise public awareness about relevant issues.

There are already several award schemes in operation. The European Commission runs the high-profile European Better Industry Awards for Industry, where the winning candidate receives a trophy and considerable public recognition.[118] A similar scheme is the Oregon Governor s Awards for Toxic Use Reduction.[119] Private institutions also award prizes such as the Goldman Environmental Prize, which recognizes achievements by environmental activists.[120]

As with most other forms of non-governmental regulation, the success of educational schemes often depends on the interests of the parties and the schemes aligning, thereby providing continuing incentives for environmental protection. For example, schemes designed to highlight the financial savings available from energy efficient products will be more likely to be successful because their adoption will aid all concerned. However, self-interest is not an essential prerequisite. There is evidence that some firms may be willing to sacrifice profit once they are made aware of the importance of curtailing environmental degradation. As the OECD has stated:

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[116] For more, see J.A. Grodsky, *Certified Green: The Law and Future of Environmental Labelling* (1993) 10(1) Yale Journal on Regulation 147.
[117] S. Dawson & N. Gunningham, *The More Dolphins There Are the Less I Trust What They re Saying: Can Green Labelling Work?* (1996) 18(1) Adelaide LR. 1.
[118] On this scheme, see J. Elkington, P. Knight & J. Hailes, *The Green Business Guide*, 1992, London: Victor Gollancz.
[119] See L.R. Jones & J.H. Baldwin, *Corporate Environmental Policy and Government Regulation*, 1994, Connecticut: JAI Press.
[120] On this, see A. Wallace, *Eco-Heroes: Twelve Tales of Environmental Victory*, 1993, San Francisco: Mercury House.

> people and businesses often care deeply about contributing responsibly to the public good (businesses also care about reputation) and governments can also use information, communications, encouragement, peer pressure, and education strategies to convince the public of the need for change. [121]

However, it appears that in many cases, this view is optimistic. Even when many firms perceive the need for environmental responsibility, they still act in a detrimental manner if the necessary measures conflict with their own self-interest. For example, in South Australia, when a number of farmers were made aware of the need for conserving biodiversity, many of them still attempted to clear their land. Only regulation stopped them from doing so. Accordingly, educational schemes only have real effectiveness when the interests of all parties align.

These difficulties are compounded when dealing with small and medium sized firms. Evidence indicates that there are difficulties in persuading such firms to act in an environmentally friendly manner even where it is in the firm s interests to do so and they are given financial incentives.[122] For example, the Department of the Environment s Small Company Environmental and Energy Management Assistance Scheme (SCEEMAS) provides a 50% subsidy for the costs of consultancy fees in the implementation of the European Union s Eco-Management and Audit Scheme (EMAS). Despite a comprehensive national advertising campaign and supplementary information, such as guides, videos and newsletters, being sent to thousands of small and medium sized firms, a subsequent review revealed that only 136 firms had participated in SCEEMAS.[123] Unsurprisingly, the scheme was abandoned.

II. THE CORPORATION AS A MECHANISM FOR EVADING ENVIRONMENTAL LIABILITY

The Corporate Veil and the Doctrine of Identification.

Ever since the House of Lords established that an incorporated company is an entity distinct from those who own it, to such an extent that there can be no relationship of

[121] OECD, *Meeting on Alternatives to Traditional Regulation*, 1994, Paris: OECD, p.8.
[122] J. Merritt, *EMS in SME Won t Go? Attitudes, Awareness and Practices in the London Borough of Croydon* (1998) 7 Business Strategy and the Environment 90 at 100.
[123] *Report on SMEs and the Environment* (for the European Commission, Directorate General Environment), Brussels: ECOTEC Research and Consulting 2000 [Online] Available http://www.europa.eu.int/comm./environment/sme/-index-htm.

principal and agent between the company owner and the company,[124] there has been debate as to who is the most appropriate party to prosecute in the event of an environmental breach; the company or its officers. Historically, the court s adherence to the corporate veil has ensured that the corporation s officers were able to hide behind the corporation s separate personality. For example, in 1991, the Herald of Free Enterprise set sail with her bow doors open, resulting in her capsizing and the deaths of 188 people. When the case came to trail,[125] the court held that P&O was responsible for the mistakes of its employees and, accordingly, the directors evaded liability.[126]

However, except in circumstances where the company is liable directly or vicariously by statute, the company will only be liable for the acts of its employees if they have the requisite authority. This is a pragmatic requirement; it is unrealistic to expect a company to oversee the actions of a workforce that may number in the thousands. The question that arises in such cases is how does the court determine whether or not the company is liable for the acts of its employees.

The doctrine of identification arose in order to answer this question. One of the earliest decisions related to this was *Lennard s Carrying Co. Ltd. v Asiatic Petroleum Co. Ltd.*[127] Here Viscount Haldane LC stated that:

> a corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation. [128]

The phrase directing mind and will was seized upon by the courts as the test for determining who was to be prosecuted. However, the test, as laid out in *Lennards*, was somewhat vague and subsequent cases needed to set it out more clearly. One of the most famous descriptions of what constitutes a directing mind and will came

124 *Salomon v A. Salomon & Co. Ltd.* [1897] AC 22.
125 *R v P&O European Ferries (Dover) Ltd.* (1991) 93 Cr. App. R. 72.
126 It should be noted that two directors and a senior manager were prosecuted for manslaughter but this charge was later withdrawn from the jury.
127 [1915] AC 705.
128 *Ibid.* at pp.713-4.

from the case of Bolton (Engineering) Co. Ltd. v TJ Graham & Sons Ltd.,[129] where Lord Denning stated:

> A company may in many ways be likened to a human body. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with directions from the centre. Some of the people in the company are mere servants or agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such. [130]

This seemingly simple test was applied in the case of *Tesco Supermarkets Ltd. v Natrass*[131] where it was held that directors, officers and senior managers of companies would be able to render their companies liable. However, it is not status *per se* that matters; what is important is that the persons in question have the authority to determine and direct company policy.[132] Technically, the liability is not vicarious. Rather, the individuals in question are thought to be so identified with the company that they embody its mind and will; they are the company.[133]

The obvious question is how will the courts determine who constitutes the brain of the company. An early English case that looked at this issue is *R v Medley*.[134] Here, a company discharged coal tar into the River Thames causing the death of several thousand fish. In determining who controlled the corporation, the court stated:

> if persons for their own advantage employ servants to conduct works, they must be answerable for what is done by those servants. [135]

A much more precise definition was given by Dickson J in the Canadian case of *R v Sault Ste Marie*:[136]

> The element on control, particularly by those in charge of business activities which may endanger the public, is vital to promote the observance of regulations designed to avoid that danger. This control can be exercised by supervision or

[129] [1957] 1 QB 159.
[130] *Ibid.* at p.172.
[131] [1972] AC 153.
[132] J. Gobert, *Corporate Criminality: New Crimes for the Times* [1994] Crim.LR. 722 at 723.
[133] Although in *Natrass*, the court held that in most cases, this will be limited to the directors, officers and senior managers, the issue of who may render the company liable will not always be clear. Lord Diplock opined that the answer may be found in the articles of association or the memoranda. See [1972] AC 153 at 200.
[134] (1834) 6 Car & P 290; 172 ER 1246.
[135] *Ibid.* at p.1250, *per* Denman CJ.
[136] (1978) 85 DLR (3d) 161.

> inspection, by improvement of his business methods or by exhorting those whom he may be expected to influence or control. [137]

The doctrine of identification, embraced by the House of Lords in Natrass, can be criticised for being too narrow and for failing to acknowledge the complexity of the modern corporation. When liability arises in the course of a company s business, it is likely to be the result of a breakdown of more than one sphere of the company s operation, not simply the directors, officers or senior managers.[138] Corporate activities may be misguided in their creation, inadequately supervised of incompetently carried out. To identify the full extent of the corporate wrongdoing would require an aggregating of all these failures. However, the courts have firmly rejected any efforts to aggregate corporate responsibility.[139]

In recent years, however, the doctrine of identification has lost some of its importance due to the trend of imposing personal liability upon certain individuals within the corporation. Most environmental statutes impose personal liabilities upon directors and officers of the company, the most notable example being s.157 Environmental Protection Act 1990:

> Where an offence committed by a body corporate is proved to have been committed with the consent or connivance of, or to be attributable to any neglect on the part of any director, manager, secretary or other similar officer of the body corporate he as well as the body corporate shall be guilty of that offence and shall be liable to be proceeded against and punished accordingly.

At first glance, this seems to cover a significant number of persons within the corporation. However, the courts appeared to have rejected a literal interpretation of the statute and interpreted it restrictively. For example, the courts, when deciding who constitutes a director will look at the individual s level of authority rather than simply their title. Accordingly, in Dean v Hiesler,[140] the respondent was acquitted because he had not been appointed by a duly convened meeting of the board.[141] Other cases look beyond the technicalities of the defendant s appointment and examine the level of authority. In R v Boal,[142] the Court of Appeal stated that:

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137 *Ibid.* at p.179.
138 J. Gobert, *Corporate Criminality: New Crimes for the Times* [1994] Crim.LR. 722 at 723.
139 R v H.M. Coroner for East Kent, ex parte Spooner (1989) 88 Cr.App.R. 10.
140 [1942] 2 All ER 340.
141 This stands in stark contrast to other areas of the law, most notably the law of agency and *ultra vires* where the rule in Turquand s case operates so as to render such appointment deficiencies irrelevant.
142 [1992] 3 All ER 177.

> The intended scope of [the section][143] is to fix with criminal liability only those who are in a position of real authority, the decision-makers within the company who have both the power and responsibility to decide corporate policy and strategy. It is to catch those responsible for putting proper procedures in place; it is not meant to strike at underlings. [144]

Normally, however, there will be little problem in determining whether an individual constitutes a director for the purposes of environmental legislation. More problematic is identifying who constitutes a manager. Again, the courts have shown a willingness to look beyond the officer s title and have attempted to determine the level of authority. In *Woodhouse v Walsall Metropolitan Borough Council*,[145] Mr. Woodhouse was the site manager of the company s main waste disposal site. Both the company and Mr. Woodhouse were convicted at first instance of storing waste in a trailer on site without the appropriate consent. On appeal, however, it was held that although he was a site manager, he was not a manager for the purposes of the legislation because he lacked the power and responsibility to decide corporate policy and strategy.

This policy of examining authority rather than title can be contrasted with the position in America. In *State v Kailua Wreckers Inc.*,[146] the defendant was the wife of the owner of the company. Although she was an officer of the company, she took no part in the running of the business. Nevertheless she was held to have managerial authority sufficient to discover and, if necessary, remedy breaches of the law. This she failed to do and accordingly, was found liable, along with the company and other officers, of unlawfully burning wrecked cars.

Accordingly, in many cases, both the company and its officers can be liable. However, it will not always be the case that all parties will be prosecuted. Sometimes the philosophy behind a provision will hint at which party or parties should be prosecuted. For example, certain provisions require clean-up campaigns or compensation for clean-up campaigns.[147] In such a case, the normal course is to bring a civil action against the company as opposed to the officers for the simple reason that

[143] In this context, s.23 Fire Precautions Act 1971.
[144] [1992] 3 All ER 177 at 181.
[145] [1994] 1 BCLC 435.
[146] 62 Hawaii 222, 615 2^{nd} 730 (1980).
[147] For example, s.161 Water Resources Act 1991.

the company will have access to greater funds; something that has come to be known as the deep pockets approach. In the case of such civil actions, the UK legislature might wish to consider the adoption of so called profit-stripping provisions similar to those seen in s.146C Ontario Environmental Protection Act 1990. Under such provisions, the court may impose an increased fine based on the amount acquired or accrued to the defendant as a result of the commission of the offence. Such a provision could help curtail the activities of those companies who prefer to breach the law rather than expend the necessary capital need to comply with environmental regulations. For such companies, the fines levied by the courts are often considerably less than the costs of making their plant, machinery and waste disposal protocols environmentally friendly. In other cases, punishing the director can have beneficial consequences. For example, when a director has been convicted of an indictable offence, he can also be disqualified from acting as a director.[148] The minimum period of disqualification is two years and the maximum period is 15 years. The value of such provisions is that directors who persistently ignore environmental legislation can be disqualified from taking part in the management of companies. In more serious cases, directors can be severely fined or imprisoned. Imprisonment is rare, but is has occurred. The first custodial sentence was announced by the Health and Safety Executive on the 23rd January 1996.[149] Ron Hill of Ridings Farm, near Bristol, was charged with offences under the Control of Asbestos at Work Regulations 1987 and the Asbestos (Licensing) Regulations 1989. Mr. Hill had demolished a building using an excavator without taking any precautions to prevent the spread of asbestos contained in roofing sheets and pipework lagging. Mr. Hill was sentenced to an immediate custodial sentence of three months and ordered to pay £4,000 costs.

The Corporation, *Mens Rea* and Strict Liability.

As regards criminal environmental liability, determining the identity of the defendant is only the first step. The prosecuting authorities will also need to establish the requisite *mens rea*. Concerning corporate environmental liability, many statutes require evidence of consent, connivance or neglect.

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[148] S.2 Company Directors Disqualification Act 1986.
[149] See Health and Safety Executive Release E13: 96.

Proof of consent seems to require the defendant to know that the illegal activity was being carried on and agreed to it. This was the conclusion of the Court of Appeal in *Attorney-General s Reference (No. 1 of 1995)*.[150] They stated that if a director consents to an illegal activity, ignorance on his part of the illegality of the act is ignorance of the law, which is no defence.

Connivance suggests acquiescence of an act which is likely to lead to the commission of an offence. In *Huckerby v Elliot*,[151] Ashworth J affirmed the following words of a stipendiary magistrate:

> Where he connives at the offence committed by the company he is equally well aware of what is going on but his agreement is tacit, not actively encouraging what happens but letting it continue and saying nothing about it. [152]

Due to the difficulties in establishing the mental elements of environmental liability, several statutory provisions now impose strict liability. For example, in *Alphacell Ltd. v Woodward*,[153] the company operated a factory in which paper was made. The layout of the plant was such that if two pumps failed, waste material would be discharged into a river. The pumps failed and the river was polluted by the waste material. The House of Lords dismissed the company s appeal against conviction for causing polluting matter to enter a stream contrary to s.2 Rivers (Prevention of Pollution) Act 1951.[154] The company had caused the pollutant to enter the river and this was sufficient to make it guilty of the offence; there was no need to establish any mental element.

The Enforcing Authorities and Prosecution Policy.

The responsibility for enforcement of regulatory laws relating to environmental offences is usually entrusted to an inspectorate rather than the police. Such inspectorates include Her Majesty s Inspectorate of Pollution (HMIP), the Environmental Agency (formerly the National Rivers Authority), the Health and Safety at Work Executive (HSE) and the Ministry of Agriculture, Fisheries and Food (MAFF), now known as the Department for Environment, Food and Rural Affairs

[150] (1996) *The Times* 30th January
[151] [1970] 1 All ER 189.
[152] *Ibid.* at p.192.
[153] [1972] AC 824.
[154] This has since been repealed and replaced by s.85 Water Resources Act 1991.

(DEFRA). Most of these inspectorates will have written policy statement indicating when they will prosecute. However, notably as regards the prosecution of individual corporate officers, both the HMIP and the Environmental Agency have no written statement of prosecution.[155] In contrast, the HSE has identified the following situations where corporate and individual prosecutions may be appropriate. Where the company is clearly solvent[156] and the commission of the offence arose due to defects in the management system, the company is the more appropriate party to prosecute. Where, however, there is a clear instance of blameworthiness on the part of the director(s) then the public interest would be best served by prosecuting the individuals.

However, whilst prosecution guidelines exist, in reality prosecutions are rare. Instead the regulatory agencies tend to adopt a compliance strategy, where the objective is not to punish the company for past offences, but to persuade it from committing future ones.[157] This compliance strategy is consistent with the self-image of regulators who tend to think of themselves as expert advisers rather than environmental police.[158]

Whilst at first, this approach may seem overly lenient, there are numerous justifications for a compliance policy. Immediate concerns may arise that demand the adoption of a compliance strategy. One example offered is where a company, through negligence, releases contaminated drugs onto the market.[159] The immediate goal should be to locate and recall the drugs before they can be taken by any consumers. Cooperation from the company is vital but is unlikely to be forthcoming if it is likely to result in the company incriminating itself. In such a situation, a voluntary agreement coupled with an agreement not to prosecute provides the company with an incentive to cooperate.

[155] P. Jewkes, *The Personal Liability of Directors in the United Kingdom for Environmental Offences* [1996] 4 Env. Liability 87 at 89.
[156] Conversely, if the company is likely to go into liquidation, then it would make more sense to prosecute the director.
[157] See Reiss, *Selecting Strategies of Social Control over Organisational Life* in K. Hawkins and J. Thomas (eds.), *Enforcing Regulation*, 1984, Boston: Kluwer.
[158] J. Gobert, *Corporate Criminality: New Crimes for the Times* [1994] Crim. LR. 722 at 725.
[159] J. Brathwaite and P. Pettit, *Not Just Desserts*, 1992, Oxford: Clarendon, pp.193-4.

The Environment and Profit Maximisation.

As has already been stated, in return for investing their capital, shareholders expect a return on their investment. In order to provide a percentage return on investor s capital, growth must occur each year. In order to achieve this, the corporation came to adopt a policy of profit maximisation.[160] We have also noted that an effective way of maximising profits is to reduce costs via a process of creating negative externalities. This will be briefly reiterated.

A corporation creates negative externalities when, in the absence of legal restraints, it successfully passes on its costs onto outside parties such as employees, creditors, the public and the environment. We have noted that such behaviour may not, in the long run, maximise profits. Nevertheless, externalities have now become an accepted part of the profit maximisation strategy and the corporation has shown itself extremely adept at taking advantage of the cost-saving benefits that externalities can offer. As Robert Monks, a former economic aid to Robert Reagan, has stated:

> the corporation as an entity became so powerful that it quickly outstripped the limits of accountability and became something of an externalizing machine, in the same way that a shark is a killing machine — no malevolence, no intentional harm, just something designed with sublime efficiency for self-preservation, which it accomplishes without any capacity to factor in the consequences of others. [161]

This is particularly true as regards environmental externalities. A classic example is the disposal of industrial waste. Most companies that have a manufacturing base will, in some form or another, produce waste products that cannot be recycled or used in the manufacturing process. As one commentator noted for every 100 pounds of product we manufacture we create at least 3200 pounds of waste. [162] In some cases, the waste products may be toxic, corrosive or radioactive. Such waste must be disposed of. At this point, the corporation has two alternatives; it can either (i) expend capital in destroying the waste or safely disposing of it or; (ii) pass the cost of waste disposal onto the environment by dumping it either at sea or at a landfill site. As corporations have an overriding objective to maximise profits, it is likely that the

[160] The arguments for profit maximisation were examined in detail in Ch. 6.

[161] R.A.G. Monks & N. Minow, *Power and Accountability*, 1991, New York: Harper Collins, p.24.

[162] P. Hawken, *Natural Capitalism*, 1997, San Francisco: Mother Jones Reprints.

latter option will be taken irrespective of the environmental damage caused. As one commentator has stated:

> The goal of the corporation is, first to survive, and, second, to return a profit to its shareholders (its legal owners) and if the air has to be fouled to accomplish these goals, then the air will be fouled. [163]

Corporations themselves have acknowledged that this is the case. In 1991, the Business Council for Sustainable Development (a private group consisting of the heads of major corporations such as DuPont and Dow Chemical) admitted:

> Today, for instance, the earth s atmosphere is providing the valuable service of acting as a dump for pollutants; those enjoying this service rarely pay a reasonable price for it. [164]

The point that needs to be stressed is that the philosophy behind environmental law and the profit maximising nature of the corporation seem to be incompatible. Looking at the above example, the philosophy behind environmental law would demand that the corporation expend the necessary capital required to dispose of the waste safely without damaging the environment. However, the theory behind profit maximisation would seem to require that the corporation take advantage of the externality on offer and pass its costs onto the environment by dumping the waste.

III. JUSTIFYING CORPORATE ENVIRONMENTAL RESPONSIBILITY.

In Chapter 7, we saw that traditional justifications for exclusive shareholder governance protection could be used to justify expanding company law protection beyond the narrow confines of the legal model. We noted that these traditional arguments could be used to justify governance protection for the employees and shareholders. Here, we will once again be using the traditional arguments to justify protection of the environment. As we have seen, traditionally environmental regulation has been left solely to environmental law with company law playing no part whatsoever. We have also seen that environmental law has been unable to effectively regulate corporations for two reasons (i) the various methods of regulation each have weaknesses, and; (ii) the corporation has demonstrated an ability to evade

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[163] P. Montague, *New Strategy Focuses on Corporation* [Online] Available http://www.envirolink.org/pubs/Rachel/rehw309.htms p.1.
[164] S. Schmidheiny *et al*, *Changing Course*, 1992, Cambridge, Mass.: MIT Press, p.9.

general environmental regulation. The second reason could be alleviated by using company law to regulate environmental activity. It is hoped that company law, with its superior knowledge, will be able to take into account the special characteristics of the company that general environmental law cannot. This will lead to provisions that cannot be so easily evaded and will be designed with corporations in mind.

Ownership of the Corporation s Assets.

As we have seen, a popular argument for exclusive shareholder governance protection is that the shareholders own the company and its assets, and accordingly have a legitimate claim to have the company run in their own interests.[165] We have also seen that this contention has proved to be extremely resistant to change despite its obvious flaws. A possible reason for this might be that a narrow definition has been adopted of the word asset.

The ownership argument seems to be premised on the contention that a company consists of nothing but capital assets, for that is all the shareholders contribute. Accordingly, the ownership argument adopts a narrow interpretation of asset based on financial factors alone. However, the dictionary definition of asset is anything valuable or useful.

This definition indicates that the financial definition is too narrow. Academics and the business community alike would agree that the assets of a company go far beyond simple capital, and as the breadth of the definition increases, so to does the claim of other parties within the corporation.

For example, there is no doubt that the employees constitute a considerable asset of the company. How many times have we heard CEO s and Managing Directors describe employees as a company s greatest asset? The ability to rent capital from creditors is also an asset. Both of these constituents have of late started to receive increased recognition from company law due to their obvious input and reliance on the firm.[166] The point that needs to be stressed is that justifications based on

[165] *Supra.* at Ch. 2.
[166] This recognition was examined in Ch. 4.

ownership are perfectly valid. It is the contention that the company itself is owned that is misleading. As noted, the company as a separate entity is incapable of being owned.[167] However, the assets are capable of being owned, but only by the company itself and this is where a legitimating principle may lie.

The question that lies at the heart of the stakeholder debate is why should non-shareholder constituents benefit from company law protection. Many commentators justify stakeholder inclusion by reference to a moral obligation — stakeholders are affected by the corporation s activities and therefore morally corporations should include stakeholder interests in the decisionmaking process. As noted, such moral arguments are unlikely to carry sufficient weight to result in departure from the legal model. Accordingly, we need a more tangible justification. The answer could lie in identifying where the corporation s assets derive from. Economics has identified four crucial assets known as the factors of production and consist of land, labour, capital and rent. If a party to the company can claim to contribute one of these assets, then it may have a right to expect the company to be run with its interests in mind. For example, shareholders and creditors contribute capital and employees contribute labour.

The environment also has such a claim. In fact, it has a multi-faceted claim. Firstly, the environment contributes land; not only the physical site of the company s headquarters but also any natural resources used by the company.[168] The other factor of production is capital. In using natural resources or by using the environment as a dumping ground, corporations reduce their costs. As profit is increased by increasing revenue or decreasing costs, the environment serves to decrease the company s capital expenditure. In effect, the amount saved is akin to a capital injection.

Therefore, the ownership argument as it stands is flawed in that it rests upon the assumption that the assets of the company are owned by those who contribute them. Assets in a broader sense are owned by and benefit the company. As the company

[167] P.L. Davies, *Gower s Principles of Modern Company Law*, 1997, 6th ed., London: sweet & Maxwell, p.301.
[168] L. Roach, *The Paradox of the Traditional Justifications for Exclusive Shareholder Governance Protection: Expanding the Pluralist Approach* (2000) 22 Co.Law. 9 at 13.

benefits, those who contribute those assets should benefit too. They certainly should not suffer for contributing to the company, as the environment does.

Residual Risk and Certain Risk.

The practice of limiting the word asset to financial assets had had the corollary of limiting the definition of risk to financial risk. The residual risk argument concentrates solely on the risk that shareholders face and as the majority of shareholders care only for their dividends, a narrow financial interpretation has come to dominate. However, as regards the environment, this interpretation is obviously inadequate.

In fact, as we shall see, regarding the environment risk is in inappropriate term. The term risk denotes a lack of certainty, the idea that a future outcome is indeterminate. We can examine the position of shareholders, employees and creditors by reference to risk because their benefits derived from the firm are indeterminate in both time and quantity. This is not the case with the environment. Many companies, particularly companies involved in the industrial sector, are going to create waste or by-products that harm the environment. There is no risk, only fact. The residual risk argument is premised on protecting the party best able to bear risk. In the case of pollution, the environment is the only party able to bear the damage, and consequently, the risk.

One reason why the environment faces certain risk is due to the corporation s desire to externalize. Corporations will try, in the absence of legal restraints, to pass on their costs to third parties.[169] These costs are known as external costs or negative externalities. A common third party to bear negative externalities is the environment. For example, the most common form of environmental external costs would be the dumping of waste products into a river. The costs of disposal have been externalized from the company and passed onto the environment. This has led to the corporation being described as:

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[169] See R.G. Lipsey, *An Introduction to Positive Economics*, 1989, 7th ed., London: Weidenfeld and Nicolson, pp. 400-2, 424-5; G. Richardson, A. Ogus and P. Burrows, *Policing Pollution: A Study of Regulation and Enforcement*, 1982, Oxford: Clarendon Press, pp. 7-10; M. Jacobs, *The Green Economy: Environment, Sustainable Development and the Politics of the Future*, 1991, London: Pluto, pp. 27-34.

> something of an externalizing machine, in the same way that a shark is a killing machine-no malevolence, no intentional harm, just something designed with sublime efficiency for self-preservation, which it accomplishes without any capacity to factor in the consequences to others. [170]

Of course, whilst externalization decreases corporate costs, it concomitantly increases social costs.[171] In order to discourage negative environmental externalities, it has been suggested that corporations be made to pay those who bear the social costs of corporate pollution.[172] As a result, corporations would install waste management and pollution disposal mechanisms as this would be cheaper than making compensation payments. However, such a solution would be unlikely to succeed for the reason that as the environment is unowned, disposal into it cannot be quantified and subsequently charged for.[173]

The Inadequacy of Contract.

As we have see, one of the few legitimate justifications for providing shareholders with primary governance protection is because they cannot protect themselves contractually. The articles of association are laid down unilaterally by management and so shareholders are forced to either adopt the directors terms or not buy into the company.

The position as regards the environment is different to other groups within the corporate nexus. The obvious difficulty is that as the environment is not an aggregate of persons; there is no identity to contract with. Therefore, the environment cannot protect itself via contract.

One solution adopted by the more enlightened companies is to contain pro-environmental provisions in the articles. For example, The Body Shop plc has four such objects:

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[170] R.A.G. Monks and N. Minow, *Power and Accountability*, 1991, New York: HarperCollins, p. 24.
[171] F.H. Easterbrook & D.R. Fischel, *The Economic Structure of Corporation Law*, 1991, Harvard University Press, p.50.
[172] A converse suggestion offered is that those who would bear social costs pay the corporation not to pollute, *i.e.* the corporation is paid the amount that the externality would save. See R.H. Coase, *The Problem of Social Cost* (1960) 3 J. Economics 1.
[173] J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, 1994, Oxford: Clarendon Press, p.312.

> (B) To institute and support (whether by donation or otherwise) campaigns or educational programs for human and civil rights [and] community projects. (C) To establish and develop equitable and responsible trading relationships, particularly in respect of community economic initiatives. (D) To implement policies aimed at protecting the natural environment (E) To institute and support campaign[s] against animal testing.

Obviously, the environment cannot sue for breach of contract. However, as noted, the articles form a contract between the shareholders and the company. Consequently, the provisions of the articles can be enforced by a member in a contract action.[174] Therefore, there is limited contractual protection. However, for two reasons this protection is ineffective.

The first reason has already been mentioned. As the directors unilaterally lay down the articles, most companies will not contain such provisions as they act as a curtailment to managerial freedom. The second reason is that in order to ensure that firms are environmentally friendly they need to expend capital. Capital expenditure means lower short—term profits. Lower short-term profit means lower or no dividends. This is unlikely to appeal to shareholders, the vast majority of whom invest simply as a means of acquiring a profit. Accordingly, as such provisions are contained in the articles, the environment is reliant on the shareholders for enforcement. As enforcement would result in both effort on the part of the shareholders and expenditure on the part of the company, the shareholders have little incentive to enforce such provisions.[175]

Given that the environment cannot protect itself via contract and the shareholders may be unwilling to, the issue has been left to statutory regulation. The provisions in question tend to follow a standard formula, the most notable example being s.157(1) Environmental Protection Act 1990:

> Where an offence under any provision of this Act committed by a body corporate is proved to have been committed with the consent or connivance of, or to have been attributable to any neglect on the part of, any director, manager, secretary or other similar officer of the body corporate or a person who was purporting to act in any such capacity, he as well as the body

[174] K.W. Wedderburn, *Shareholders Rights and the Rule in Foss v Harbottle* [1957] CLJ 194 at 209-15.

[175] L. Roach, *The Paradox of the Traditional Justifications for Exclusive Shareholder Governance Protection: Expanding the Pluralist Approach* (2000) 22 Co.Law. 9 at 14.

> corporate shall be guilty of that offence and shall be liable to be proceeded against and punished accordingly. [176]

These provisions, however, are part of environmental law and this is the area of the law that has come to regulate the company s environmental activity. Company law has had little part to play for the simple reason that the philosophy behind these environmental provisions is at odds with the philosophy behind company law.

Company law s preoccupation with profit has been a major factor in its exclusion from the realm of environmental regulation. Profits are increased by either increasing revenue or decreasing costs. As we have noted, corporations decrease costs via a process of externalization. In order to protect the environment corporations must cease externalizing their costs. As a result, the corporation will no longer have a free dumping ground and will be forced to expend capital so as to provide a means of safely disposing of waste. This is where company law and environmental law diverge. The philosophy behind environmental law would dictate that the corporation expends capital as opposed to externalize costs. Conversely, the profit maximization preoccupation of company law would dictate that the corporation takes advantage of the environment as a means of reducing costs. As has been noted:

> The goal of a corporation is, first, to survive, and, second, to return a profit to its shareholders (its legal owners) and if the air has to be fouled to accomplish these goals, then the air will be fouled. [177]

Conclusion.

In Chapter 7, we saw that the traditional justifications for exclusive shareholder governance protection could be used to justify expanding the scope of company law protection to include the company s employees and creditors. Here we use the same justifications to justify environmental protection.

The ownership argument is often premised upon the derivation of capital. Legal model theory contends that as the shareholders contribute the capital, they own the company. They therefore have a right to have the company run in their interests. We

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[176] Examples of similar provisions include s.52 Clean Air Act 1993, s.36 Radioactive Substances Act 1993, s.217 Water Resources Act 1991 and s.210 Water Industry Act 1991.
[177] P.Montague, *New Strategy Focuses on Corporations* [online] Available http://www.envirolink.org /pubs/ rachel/rehw309.htms p.1.

saw in Chapter 7 that other constituents can also contribute capital. The same is true of the environment. Of course, as with the employees and the creditors, no ownership claim is established. However, the claim is no weaker than that of the shareholders.

It could be argued that in relation to the residual risk argument, the claim of the environment is stronger than that of the shareholders. The risk that the shareholders face can be minimised via a diversified portfolio. Therefore, the shareholders can protect themselves against the risk that they face. The environment cannot.

Likewise, the environment cannot protect itself via contract. Neither can the shareholders, yet their lack of contractual protection warrants company law intervention. Legal model theorists justify this by saying that there is a gap in the protection offered to the shareholders and so company law should fill this gap. The only way that the environment can gain contractual protection is if such a provision is put in the articles. As we have seen, this is unlikely. Therefore there is a gap in the environment s protection.

CONCLUSION.

Corporate environmental regulation has been left to general environmental law as opposed to company law. Numerous regulatory methods have arisen to combat the increase in environmental degradation. As we saw in Part I, the various methods have much to offer. However, no one method is totally effective with each having weaknesses that need to be offset by the strength of the others. What is needed is a mixture of regulatory methods. To date, this has not happened.

What makes corporate regulation even more difficult is the fact that the corporation has shown itself adept at evading environmental provisions. Part II saw that the corporation has a number of unique characteristics that make environmental regulation extremely difficult. These unique characteristics need to be taken into account when drafting environmental provisions. This is a matter for company law, not general environmental law.

Company law s involvement in environmental matters will need a stronger justification. Possible justifications were examined in Part III. These were the same justifications examined in Chapter 6 and used to move away from a legal model position in Chapter 7. These justifications demonstrate that the position of the environment is akin to that of the shareholders. Both parties can be deemed to have ownership claims, albeit not particularly strong ones. Both parties bear risk from the activities of the company. Finally, both parties are unable to effectively protect themselves via contract. This leads us to conclude that the environment is deserving of more attention from our company law.

10

The Proposed Statement of Directors Duties and the Operating and Financial Review

INTRODUCTION.

As we have noted, companies legislation has never sought to formally prescribe the role of the director. However, it has been contended that there is little doubt that the directors are responsible for the smooth running of their companies.[1] As the Cadbury Committee stated boards of directors are responsible for the governance of their companies. [2] Given their key role, their duties form one of the central issues in company law. However, currently, their duties are to be found in a confusing and compendious mass of case law and the occasional statutory measure. These in turn are supplemented by regulations in the company s articles, and various provisions in the *City Code on Takeovers and Mergers*, the *Listing Rules* and the *Combined Code.* As we saw in Chapter 4, the various measures that seek to prescribe to whom these duties are owed are not particularly coherent.

Given this, for many years, there has been discussion of a statutory statement of directors duties that would consolidate and codify the existing case law and statute law into one clearer, formal statement of directors duties. A major step toward this was taken in 1999 when the Law Commission formally recommended that directors duties be made statutory and offered a proposed statement.[3] The Law Commission s examination was a necessary one given the lack of clarity in this area of the law. However, its remit was a limited one. In particular, whilst the Law Commission examined the content of directors duties, it did not examine the issue of to whom these duties would be owed to.[4] Fortunately, as we shall see, the Government shortly after instigated a fundamental review of company law. It became inevitable that this would include a thorough examination of directors duties. This review was carried

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[1] J. Birds, *The Reform of Directors Duties* in J. de Lacy (ed.), *The Reform of United Kingdom Company Law*, 2002, London: Cavendish, p.149.
[2] *Report on the Financial Aspects of Corporate Governance*, 1992, London: Gee, para.2.5.
[3] See the Law Commission Report No. 261, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties*, 1999, Cm. 4436, London: TSO. Note that the actual arguments for and against a statutory statement of duties will not be examined here.
[4] The Law Commission acknowledged this at para.1.32.

out by the Company Law Review Steering Group (CLRSG) and it is to their work that we now turn.

I. THE DRAFT STATEMENT OF DIRECTORS DUTIES.

The CLRSG was set up in 1998 by the then Secretary of State for Trade and Industry, Margaret Beckett, to devise a framework of company law which facilitates enterprise and promotes transparency and fair dealing. [5] The first consultation document set out its objectives as, amongst others, to provide straightforward, cost-effective and fair regulation which balances the interests of business with those of shareholders, creditors and others. [6] In relation to this objective, the most difficult task faced by the Review was to determine the objectives that companies should aspire to and to take into account the range of interests that directors need to balance. The Review termed this the scope of company law. [7]

The February 1999 consultation document acknowledged what we have already demonstrated in Chapters 4 and 5, namely that our current system of company law operates largely to benefit the shareholders.[8] It then went on to advocate two possible areas of reform, which it termed the enlightened shareholder value model and the pluralist model. The main difference between these two models lies in relation to what happens when there is a clash of interests between the shareholders and the other stakeholders.[9] The enlightened shareholder value model, which was later to become what is known as the inclusive approach, stated that the shareholder s interests should prevail. Conversely, the pluralist model argues that the directors should balance these potentially conflicting interests, without giving automatic priority to the shareholders.[10] Both of these models will now be examined.

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[5] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy*, March 1998, London: DTI, Foreword.
[6] *Ibid.* at para.5.1.
[7] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework*, February 1999, London: DTI, Ch.5.
[8] *Ibid.* at paras. 5.1.4-5.
[9] J. Parkinson, *Inclusive Company Law* in J. de Lacy (ed.), *The Reform of United Kingdom Company Law*, 2002, London: Cavendish, p.44.
[10] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework*, February 1999, London: DTI, para.5.1.13.

The Inclusive Model.

The February 1999 consultation document stated that enlightened shareholder value model advocates argue that the ultimate objective of companies as currently enshrined in law —*i.e.* to generate maximum value to shareholders — is in principle the best means also of securing overall prosperity and welfare. [11] Basically, this view is the same as that espoused by Friedman. Although many favoured this view, subsequent consultations revealed that many viewed this model as being too narrow. Those involved in the consultation process expressed a hope that the duty would be framed in an inclusive way. [12] This meant that whilst the shareholder primacy element would be retained, this would need to be balanced with the need to foster effective relationships over time, with employees, customers and suppliers, and in the community more widely. [13] Following this, the enlightened shareholder value model soon became known as the inclusive approach.

The inclusive approach is premised upon the belief that long-term profit maximisation can only occur through the fostering of co-operative relationships with the various non-shareholder constituents. Taking the employees as a major non-shareholder group, as we saw in Chapter 7, factors such as optimal employee effort and innovation cannot be contracted for. Factors such as these are necessary to attaining long-term financial well-being, and as they cannot be contracted for, they can only be achieved if the parties trust each other.

It has been argued that such relationships of trust between the company and its employees have become crucial in the modern economy given that technological innovations means that the abilities of the workforce are an important factor governing the company s ability to compete.[14] We also saw in Chapter 7 that employees may be reluctant to gain firm-specific skills if they do not trust the

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[11] *Ibid.* at para. 5.1.12.

[12] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, March 2000, London: DTI, para.2.11.

[13] *Ibid.*

[14] P.F. Drucker, *Post-Capitalist Society*, 1993, Oxford: OUP, pp.19-47.

company s management. Employees that trust their employers will be eager to acquire firm-specific skills and this in turn can have a positive effect on profits.[15]

That long-term co-operative relationships with employees are crucial to corporate prosperity is starting to become acknowledged. Both the RSA[16] and the Commission on Public Policy and British Business[17] have stated that the poor performance of British companies can be attributed in part to the failure to cultivate long-term relationships of the kind discussed. The CLRSG hopes that the adoption of an inclusive approach will result in a long-term perspective that can result in co-operative relationships.

There is practical evidence that employee prosperity can have beneficial effects. The American company, Ben & Jerry s Homemade Inc., strives to aid its employees in various ways. It offers a variety of employee benefits including generous life, health and disability insurance plans, an employee stock purchase plan and an employee profit-sharing plan to which Ben & Jerry s contributes 5% of its pre-tax earnings, as well as free health club memberships and affordable day care. The employees are also allowed to take home three free pints of ice cream every workday. By traditional measures, the company treats its employees extremely well. The firm s employees recognize this. An independent survey of the attitudes of Ben & Jerry s employees indicated that its employees are far happier in their jobs than employees in other American companies. Employees in turn believed that they were far more productive because of this.[18]

However, the inclusive approach goes further than requiring co-operative relationships with employees and other parties within the supply chain. It also states that wider responsibilities such as those to the community and the environment are also vital to corporate success. It has been argued that responsible behaviour of this kind can result in increases in profits by reducing costs, *e.g.* certain environmental

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[15] J. Kay, *Foundations of Corporate Success: How Business Strategies Add Value*, 1993, Oxford: OUP, chs. 3-5.
[16] RSA Inquiry, *Tomorrow s Company: The Role of Business in a Changing World*, 1995, London: RSA.
[17] Commission on Public Policy and British Business, *Promoting Prosperity: A Business Agenda for Britain*, 1997, London: Vintage.
[18] Ben & Jerry s Homemade Inc., *1990 Annual Report*, 1992, Vermont: Ben & Jerry s, p.10.

initiatives such as waste recycling and energy conservation can have positive effects on profit margins.[19] Acting in a socially responsible manner can also reduce costs in that it can create its own advertising.

For example, since 1989, Ben & Jerry s has supported a non-profit organisation, 1% for Peace, which consists of two entities: an educational foundation and a legislative action campaign that supports the passage of legislation allocating 1% of the US defence budget to programs to build understanding between nations. Not only has the company named its chocolate and nut ice cream bar the Peace Pop but also the company s Foundation allocates 1% of the company s pre-tax earnings to 1% for Peace. The company prints an explanation of the cause and its involvement on the ice cream s packaging. Although some retailers initially refused to carry the product, believing it to be too political, the huge advertising surrounding the product, none of which Ben & Jerry s asked for or paid for, soon made the product a huge success.[20]

However, Ben & Jerry s has actually gone further than the inclusive approach envisages. In supporting local communities, Ben & Jerry s actually adopts measures guaranteed to lower profits without the expectation of regaining those profits through increased productivity or customer goodwill. The company has a policy of paying higher prices to support dairy farmers in Vermont. As Ben Cohen stated, $500,000 annually will come out of our profits, where it doesn t belong, and into farmers pockets, where it does belong. We refuse to prop up our bottomline with bankrupt family farms. [21] Other companies have also sought to alleviate social problems in such a way. In 1988, the Body Shop plc. created a subsidiary known as Soapworks Ltd. The company decided to base this factory in Glasgow in an attempt to mitigate the area s astonishingly high (70%) unemployment rate.[22]

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[19] J. Braithwaite and P. Drahos, *Global Business Regulation*, 2000, Cambridge: CUP, pp.267-9.
[20] See L.D. Solomon, *On the Frontier of Capitalism: Implementation of Humanomics by Modern Publicly Held Corporations — A Critical Assessment* in L.E. Mitchell (ed.),*Progressive Corporate Law*, 1995, Boulder, Colorado: Westview Press, p.291.
[21] Ben & Jerry s Homemade Inc., *1991 Annual Report*, 1992, Vermont: Ben & Jerry s, p.7.
[22] A. Roddick, *Body and Soul*, 1991, pp.155-9.

Companies such as Ben & Jerry s and The Body Shop are exceptional.[23] However, whilst many companies will not voluntarily act as responsibly as the above companies, there are incentives to stop them acting irresponsibly. The last decade has witnessed an increase in market penalties aimed at those firm who behave irresponsibly. The most obvious form of market penalty is an organised boycott of a company s products. There have been several recent notable boycotts including those against Nestl (for selling infant milk formula to developing counties), Shell (for the disposal of the Brent Spar Oil facility in the North Sea) and Nike (for sweatshop conditions in overseas factories.)[24] However, whilst the media coverage at the time was significant, it appears that the high-profile campaigns against these companies had little or no effect upon the share price. One unpublished study investigating the financial effects of the Nike, Nestl and Shell campaigns concluded that:

> [Whilst] not investigated in a scientific way the examples show that the negative press referring to specific incidents is not proved to have a long-term negative effect on the price of the company s shares. [25]

This has led one commentator to state that, based upon his own survey:

> the company that did worst in [my social responsibility] rankings — News International — actually had the largest share price rise. Clearly the public s purchasing of shares is still not greatly affected, as yet, by the companies level of social responsibility. [26]

However, a more effective method of consumer pressure is beginning to emerge, namely ethical purchasing. A recent report on ethical purchasing in the UK commissioned by the Co-operative Bank found that around 5% of the population claimed to base their purchases on ethical considerations. 18% said that they frequently bought or avoided products depending on the manufacturers social reputation. The survey concluded by stating that around half the population have, at some point, chosen a product because its manufacturer had a positive social reputation

[23] It is interesting to note that the responsible reputation that Ben & Jerry s and The Body Shop have cultivated can actually backfire should these companies not sustain their whiter than white reputation. In the mid-1990s, both of these companies came under public attack for misleading their customers and the public in their claim to be socially responsible.

[24] For other case studies, see N. Craig Smith, *Morality and the Market: Consumer Pressure for Corporate Accountability*, 1990, London: Routledge, Ch.8.

[25] Quoted in S. Zadek, *The Civil Corporation: The New Economy of Corporate Citizenship*, 2001, London: Earthscan, p.61.

[26] M. Hopkins, *The Planetary Bargain*, 1998, London: HarperCollins, p.56.

or rejected a product because of a poor social reputation.[27] A survey carried out in America by Cone Inc. found even greater evidence of ethical purchasing. The study found that 65% of Americans, nearly 130 million consumers, stated that they would be likely to switch brands or retailers to another associated with a good cause.[28]

This slow move toward ethical purchasing is indicative of a shift in the views of consumers regarding the role of corporations. In this respect, the results of the Millennium Poll on consumer expectations of corporate social responsibility are significant. The poll covered 23 countries on six continents and interviewed over 25,000 consumers. The survey found that, across the globe, roughly two in three consumers want companies to go beyond the legal model goal of profit maximisation and contribute more to achieving broader social goals. Over half the Europeans, and 71% of those in the UK, believed that businesses did not pay enough attention to their social responsibilities.[29] Other surveys have found similar trends.[30]

This inclusive approach is certainly provocative. It suggests that societal well-being and profit making can go hand-in-hand over the long-term.[31] Certainly, this perception of a win-win situation is becoming popular. The World Business Council for Social Development certainly recognises that profit and social responsibility can go hand-in-hand:

> Concern is sometimes expressed that corporate social responsibility has no clear business benefits and could destroy shareholder value by diverting resources from core commercial activities However, the WBCSD supports the view that a coherent CSR strategy based on sound ethics and core values offers clear business benefits. [32]

[27] R. Cowe and S. Williams, *Who are the Ethical Consumers?*, 2000, Manchester: The Co-operative Bank.
[28] Cone Inc., *Cone/Roper Cause Related Trends Report: Evolution of Cause Branding*, 1999, Boston: Cone Inc.
[29] Environics International Ltd., *Executive Briefing: The Millennium Poll on Corporate Social Responsibility*, 1999, Toronto: Environics International Ltd.
[30] See *e.g.* The Conference Board Inc., *Consumer Expectations on the Social Accountability of Business*, 1999, New York: The Conference Board, pp.9-13; Fleishman Hillard, *Consumers Demand Companies with a Conscience*, 1999, London: Fleishman Hillard Europe.
[31] P. Utting, *Business Responsibility for Sustainable Development*, 2000, Geneva: United Nations Research Institute for Social Development, p.7.
[32] World Business Council for Social Development, *Corporate Social Responsibility*, 1999, Geneva: WBCSD, p.2.

Some have argued that this recognition defeats the Friedman view that the social aim of business is to increase its profits.[33] Alice Tepper-Marlin, the President of the Council on Economic Priorities, stated Milton Friedman, the prime advocate of the position that the responsibility of business is exclusively to maximize profit for shareholders, has lost the debate. [34]

However, it has been argued that inclusive approaches of this kind are a sophisticated restatement, rather than a refutation, of Friedman s proposition.[35] Friedman said that business should not only comply with the law but also with the expectations of the societies within which they operate. From this viewpoint, the inclusive approach more or less states this by saying that businesses should address new social norms that arise.

The idea that profits and principles can go hand-in-hand has not been accepted wholeheartedly. Korten has argued that there is a trade-off between profits and principles. For this reason, he argues that ethical firms are eventually pushed out of a competitive market.[36] Many however, disagree. Mark Goyder, the head of the Centre for Tomorrow s Company, believes that tomorrow s successful companies will necessarily be those who adopt an inclusive view to their stakeholders.[37]

In conclusion, although the inclusive model shares the current goal of the legal model (that is to maximise profits), it does it in a way that encourages a broader societal outlook. As we have seen, this does not only involve the traditional stakeholder constituents in the supply chain, but actually encompasses the community and the environment. The traditional legal model outlook states that profit maximisation is best achieved via corporate policies that seek to benefit the shareholders. The inclusive approach differs in that it focuses on those long-term relationships that can exist between parties inside and outside the corporation. It is the aim of the inclusive

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[33] The views of Friedman were examined in Chapter 6.
[34] Confederation of British Industry, *Global Social Responsibility*, 1999, London: CBI, p.2.
[35] S. Zadek, *The Civil Corporation: The New Economy of Corporate Citizenship*, 2001, London: Earthscan, p.53.
[36] D. Korten, *When Corporations Rule the World*, 1997, West Hardford, Conn.: Kumarian.
[37] M. Goyder, *The Living Company*, 1998, Aldershot: Gower.

approach to better foster these relationships.[38] It is too early to state whether or not the inclusive approach can start to marry profits and principles.

The Pluralist Model.

Whilst, over the long-term, the interests of the shareholders and other constituents will coincide, this will not always be the case. Conflicts of interest will arise. Under the inclusive approach, upon the occurrence of such conflicts, preference should be given to shareholder interests. This means that non-shareholder constituents are going to suffer. The pluralist position contends that preference should not automatically be given to the shareholders but that the management should seek to balance these potentially conflicting interests.[39]

The pluralist model has an economic justification. Giving the shareholders automatic priority will not always be the most efficient response. As we saw in Chapter 7, employees often make firm-specific investments in their companies. Employees who believe that priority will automatically be given to the shareholders may be reluctant to make such investments.[40] Likewise, it is not always the case that social responsibility and long-term profit maximisation are consistent. Acting in a socially and environmentally responsible way may have the effect of reducing profits by increasing costs. As we saw in Chapters 6 and 9, a common mechanism of profit maximisation is to externalise costs onto parties outside the company. Acting in a socially and environmentally responsible way may mean foregoing opportunities to externalise these costs with the result that the company s costs will increase which will in turn reduce profits.

Adoption of a pluralist approach would require a significant redefinition of directors duties. Instead of defining the company simply as the aggregate of shareholders, a new definition would have to be determined that would take into account all of the other relevant groups. Much of what we have looked at in previous chapters would become a reality. For example, adoption of a pluralist approach may require the

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[38] J. Parkinson, *Inclusive Company Law* in J. de Lacy (ed.), *The Reform of United Kingdom Company Law*, 2002, London: Cavendish, p.48.
[39] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework*, February 1999, London: DTI, para.5.1.13.

company to honour its implicit promises to its employees, even though, as we saw in Chapter 7, such promises are unenforceable at law. Also if the position of non-shareholder constituents were to become more prominent, these constituents may begin to require representation or protection from the corporate governance mechanisms examined in Chapter 6. Such reform would be extremely extensive.

The View of the CLRSG.

Before looking at the recommendations of the CLRSG, it is interesting to note the parallels between the work of the CLRG and the Harvard Debate examined in Chapter 1. The two views put forward by the CLRSG are, in essence, the same views as those put forward by Berle and Dodd over 70 years ago. The view of Berle was that the shareholders should retain primacy. This view is very similar to the view espoused by the inclusive model, albeit that the inclusive model now recognises that wider constituents and their relationships with the shareholders can have a positive impact on the company s profits. The view of Dodd was that the company should take into account a community of interests and that the directors should balance these interests and not automatically prioritise the interests of shareholders. This view is essentially identical to the pluralist model of the company.

We noted that on paper, the Harvard Debate was won by Dodd. We also, however, noted that, historically, it is Berle s view that has been dominated. This view is supported by the view of the CLRSG who recommended that the inclusive approach be adopted.[41] Although the Review did express some support for the objectives behind the pluralist approach,[42] their main concern was that they could see no practical way of enforcing such a duty.[43] This was exactly the principal objection of Berle in relation to Dodd s community standard.[44]

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[40] *Ibid.* at para. 5.1.24.
[41] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, March 2000, London: DTI, para.2.22; Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, November 2000, London: DTI, para.3.5.
[42] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, March 2000, London: DTI, para.2.21.
[43] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, November 2000, London: DTI, para.3.5.
[44] A.A. Berle, *For Whom Corporate Managers Are Trustees: A Note* (1932) 45 Harv.L.Rev. 1365 at 1367.

The Review went on to identify a number of other problems. If the pluralist view were adopted, then the directors would have to balance the views of numerous groups within the corporate nexus. Such a duty would probably have to be subjective. If the duty were objective, this would give an overly wide discretion to the court; a discretion that the court cannot be expected to realistically desire or exercise.[45] However, a subjective duty would in practice amount to little more than discretion and this discretion would be largely unpoliced.[46] In any case, it may be that the objectives of the pluralist duty can be achieved via an inclusive approach. Provided that the law makes it clear that the inclusive approach should maximise the community of interests between shareholders and wider constituents, then the Review believes that a pluralist approach is largely unnecessary. [47]

Given the above, the CLRSG drafted its statement of directors duties with an inclusive approach in mind. It is also intended that the new statement should significantly clarify the law in this area. The current law is based in a complex series of cases. Recent developments, examined in Chapter 4, have served to complicate the law rather than clarifying it. This lack of understanding was demonstrated by an Institute of Directors study carried out in 1999 which stated that many directors believed that the law required them to maximise short-term shareholder benefit at the expense of long-term profit.[48]

In line with the philosophy behind the inclusive approach, the central obligation is to promote the success of the company for the benefit of its members. [49] This upholds the current legal model view that the shareholders interests override all other parties within the corporate nexus. However, the statement then goes on to list other material factors that the directors must take into account. These include the company s need to foster its business relationships, including those with its employees and suppliers

[45] J. Parkinson, *Inclusive Company Law* in J. de Lacy (ed.), *The Reform of United Kingdom Company Law*, 2002, London: Cavendish, p.50.
[46] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, March 2000, London: DTI, para.3.24.
[47] *Ibid.*
[48] Institute of Directors, *Good Boardroom Practice*, 1999, London: IOD.
[49] Schedule 2 para. (2)(a) Draft Statement of Directors Duties. This central obligation is subject to the requirement to comply with the company s constitution and the duty to act for a proper purpose.

and the customers for its products and services [50] and its need to have regard to the impact of its operations on the communities affected and on the environment. [51] This is also indicative of an inclusive approach in that it attempts to bring together shareholder and stakeholder interests. The central aim of shareholder wealth maximisation is achieved by building successful relationships with members of the supply chain and the community and the environment. The issue of short-termism is addressed by the requirement that directors should take into account both the long-term and short-term consequences of their acts.[52]

This statement of directors duties has now been accepted by the government in its recent White Paper.[53] Some qualifications were made in relation to creditors but these have already been discussed in Chapter 4 and will not be re-examined here.

II. THE OPERATING AND FINANCIAL REVIEW (OFR).

It has been argued that the approach taken by the CLRSG places less emphasis on a modification of directors duties and more emphasis on increased disclosure obligations.[54] In this respect, the CLRSG s proposals for a mandatory OFR are of crucial importance. The emphasis on increased disclosure is intended to respond to the numerous criticisms aimed at the current reporting regime, namely that it is too narrow in scope and pays attention only to tangible assets whilst ignoring less tangible assets such as human capital, soft assets and the company s effect on the environment.[55]

The CLRSG responded to these criticisms by recommending that sizeable public companies and a small number of very large private companies[56] should produce an

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[50] Schedule 2 para. (2)(2)(a) Draft Statement of Directors Duties.
[51] Schedule 2 para. (2)(2)(b) Draft Statement of Directors Duties.
[52] Schedule 2 para. (2)(1)(a) Draft Statement of Directors Duties.
[53] DTI, *Modernising Company Law*, July 2002, Cm. 5553-I, London: DTI.
[54] J. Birds, *The Reform of Directors Duties* in J. de Lacy (ed.), *The Reform of United Kingdom Company Law*, 2002, London: Cavendish, p.160.
[55] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, March 2000, London: DTI., para.5.74.
[56] The CLRSG recommended that the exact thresholds need further research. For their proposals, see DTI, *Modernising Company Law*, July 2002, Cm. 5553-I, London: DTI., para. 4.36, who recommend that in order to qualify a public company needs to meet two of the following three criteria: (i) turnover exceeding £50 million, (ii) balance sheet total exceeding £25 million, and (iii) employees exceeding 500. For private companies, the figures are (i) £500 million, (ii) £250 million, and (iii) 5,000 respectively.

OFR. The purpose of the OFR will be to provide a discussion and analysis of the performance of the business and the main trends and factors underlying the results and financial position and likely to affect performance in the future, so as to enable users to assess the strategies adopted by the business and the potential for successfully achieving them. [57]

The Review put forward seven headings to be covered by the OFR. Of these, three are mandatory.[58] However, in relation to the inclusive approach, it is the other four headings that are most relevant. These categories include:

- An account of the company s key relationships with employees, customers, suppliers and others, on which its success depends;
- Corporate governance — values and structures, and
- Policies and performance on environmental, community, social, ethical and reputational issues including compliance with relevant laws and regulations.

It should be noted that reporting on the above issues is not mandatory, but rather a matter for the director s good faith and judgment in determining if the above is material. Given this, it could be argued that these proposals do not go quite far enough.[59] Given that the OFR will only apply to very large companies, it is difficult to see how headings relating to the environment or the workforce can ever be immaterial in understanding the business. This may lead to piecemeal reporting which will compromise the goal of financial transparency that the OFR aims for. Gaps will remain, most notably in areas where the company needs to improve and the market may view such omissions and assume the worst.

Against this is the fact that the process determining what the directors put in the OFR will be subject to review by the auditors and should the auditors believe that the process by which the directors determined materiality is insufficient, then they can make the company produce a revised OFR. Further, if all of the headings were made mandatory, then there is reason to believe that this would be overly prescriptive. A concern that arises several times is that if all of the headings were made mandatory,

[57] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, March 2000, London: DTI, para.5.79.
[58] These are (i) the company s business and business objectives, strategy and principal drivers of performance, (ii) a fair review of the development of the company s business and (iii) the dynamics of the business.
[59] J. Parkinson, *Inclusive Company Law* in J. de Lacy (ed.), *The Reform of United Kingdom Company Law*, 2002, London: Cavendish, p.57.

this could lead to what has been termed boilerplate reporting, where the report is made in a perfunctory manner rather than taking into account the actual situation of the company.[60]

However, one criticism that auditor review does not alleviate is the idea that the OFR is designed solely with the information needs of the shareholders in mind. The original CLRSG recommendations were more open-ended about to whom the OFR should be directed. As we have seen, the CLRSG adopted an inclusive approach in relation to the scope of company law issue. One of the aims of the inclusive approach is to align corporate behaviour with market and societal pressures for improved social and environmental performance with a mind to improving shareholder monitoring of the company s response to these pressures. As the White Paper notes,[61] the information disclosed will be of value to consumers, employees and NGOs, who are the sources of external pressure, but what is actually reported is not determined by their information needs.

The above proposals aim to improve several notable areas of weakness in our corporate governance system. The basic aim is that the OFR will improve performance in the areas that are subject to disclosure. This will be achieved by providing interested parties (not just the shareholders) with information on how well the company is performing in these areas. Those parties who do not feel that the company is performing as well as it should can then exert pressure on the company based on the information they have received. Finally, we saw in Chapter 5 that the market for corporate control relies on what is known as the Efficient Capital Market Hypothesis (ECMH). The ECMH basically states that the company s share price reflects the company s performance. We also saw in Chapter 5 that there are several factors that serve to weaken the ECMH s ability to disseminate information into the market. The result is that the company s shares may not be accurately priced. It is hoped that the OFR s increased disclosure obligations will result in more information being available to the share market which in turn will lead to an increase in the

[60] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, June 2001, London: DTI, para.3.35.
[61] DTI, *Modernising Company Law*, July 2002, Cm. 5553-I, London: DTI, para.4.32.

accuracy of share prices.[62] If the share price can take into account long-term stable relationships of the kind envisaged by the inclusive model, then short-term pressures are likely to be reduced.

The potential of the OFR is encouraging. However, reporting of this type is still at an embryonic stage. Given this, between November 2000 and February 2001, a study using a trail OFR was carried out by The Industrial Society using five companies[63] and four audit firms.[64] The five companies produced trail OFRs on which the auditors gave their views (although they did not audit them). All participants were extremely positive about the OFR s ability to improve reporting and there was a general consensus that the OFR was an idea whose time has come. [65] However, only once the proposal is introduced formally will the true results be known. There are strong indicators to believe that the OFR can result in an increase in the quality of reporting and the accuracy of what is reported.

CONCLUSION.

Even though the approach taken by the CLRSG is in essence a shareholder-centred one, it would be wrong to classify it as an affirmation of the legal model in its strictest form. The legal model holds that companies should act exclusively in the interests of their shareholders. This is not the view of the inclusive approach. The approach adopted by the CLRSG attempts to increase shareholder wealth by building long-term, stable, co-operative relationships with all parties within the supply chain. If this can be achieved then all parties within the corporate nexus should benefit.

The approach taken by the Review even goes so far as to include the community and the environment in its list of relevant factors for the directors to take into account. This is a fundamental inclusion. As we have seen, the inclusion of stakeholders such as the employees and the creditors is relatively uncontroversial. The inclusion of wider constituents such as the community is a radical reform given the influence that

[62] J. Parkinson, *Inclusive Company Law* in J. de Lacy (ed.), *The Reform of United Kingdom Company Law*, 2002, London: Cavendish, p.52.
[63] These were British Airways plc., British Telecommunications plc., Clydesdale Bank plc., Great Universal Stores plc. and ITNET plc.
[64] These were Ernst & Young, Grant Thornton, KPMG and PriceWaterhouseCoopers.

the legal model has had over the last century. Nevertheless, these reforms have been accepted by the Government and will form part of the next Companies Act.

The CLRSG is to be praised for taking a brave step towards doing what Dodd and numerous other academics have been unable to do for the last century, namely to begin the process of designing a mechanism to include wider constituents within directors duties. Whilst the steps taken have not been radical departures from the legal model, they are nonetheless significant. Hopefully, the recommendation of the CLRSG will ultimately lead to a full realisation of the community standard the Dodd envisaged.

[65] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, June 2001, London: DTI, para.3.38.

Conclusion

This thesis ends with the quote that began it. Over seventy years ago, Adolf Berle stated:

> It is the thesis of this essay that all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears. [1]

In doing so, Berle commenced the Harvard Debate and ignited a spark that has burned amongst the corporate academic community since. Whilst the technical arguments of Berle and Dodd are no longer relevant to justify their respective contentions, the issue that they brought to the fore has been of paramount importance since. As the validity of the legal model comes under increased scrutiny, contemporary commentators are starting to revisit the Harvard Debate and the work of Dodd, Berle and Means. In examining the Law Commission s consultation paper concerning a draft statement of directors duties, one prominent commentator stated Berle s work and the debates which it generated over half a century ago still provide important insights into the fundamental questions underlying not only the duties of directors of large public companies but corporate governance in general. [2] The question posed in the Harvard Debate is exactly the same question that this thesis is concerned with, namely in whose interests should the corporation be run.

The quote above exemplified Berle s pro-shareholder view. It also exemplifies the view espoused by the legal model of the company. Berle, more than anyone else before him, had demonstrated how pro-shareholder the law was. There is little doubt that he was the first champion of the legal model of the company.

As we saw in Chapter 1, Berle s view was not without its critics and Dodd offered a conception of the company based not on a pro-shareholder view, but on the view that the company had an obligation to act for a community of interests. We also noted that on paper, Dodd won the debate when Berle conceded in 1954. However, in reality,

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[1] A.A. Berle Jr., *Corporate Powers As Powers in Trust* (1930-1) 44 Harv. L. Rev. 1049 at 1049.
[2] P. Ireland, *Back to the Future? Adolf Berle, the Law Commission and Directors Duties* (1999) 20 Co.Law. 203 at 204.

Although they are not proposing such a rigorous reaffirmation of the shareholder primacy principle as Berle did, their reasons for not expanding the duty are the same. There was no workable scheme for enforcing a pluralist standard in the 1930s and there is still no workable scheme. Berle was not anti-stakeholder — quite the opposite — he simply could not see any way of dealing with the growth of managerial power other than a reaffirmation of the legal model. He believed that legal mechanisms that took into account the interests of stakeholders would take time to develop and until then we should protect the interests we know. [5] History has proven him correct. We are starting to realise that non-shareholder interests are worthy of protection and the proposals by the Company Law Review Steering Group are the first real step in legally acknowledging this. They are still however, heavily influenced by the legal model of the company.

The Harvard Debate is a perfect metaphor for the stakeholder debate. Although Berle lost the debate, the law has not changed in a way that significantly recognises pluralist interests (although it is hoped that the new proposals will alter this). Similarly, although many academics and business leaders will argue that the key to corporate prosperity is the fostering of long-term relationships with all members of the corporate nexus, the law has not altered to reflect this. By and large, the law still upholds the legal model of the company.

The Harvard Debate provides a useful introduction into the stakeholder debate. However, although the principles are as relevant today as they were then, the reasoning offered for their respective positions have not aged as well. Both Berle and Dodd in advocating their positions advanced trustee-based arguments, albeit in a metaphorical rather than a literal manner. Today directors cannot be considered to be trustees for the shareholders. Accordingly, new theories need to be found.

Pro-legal model theorists resorted to perhaps the oldest justification for shareholder primacy, namely the idea that the shareholders owned the company and so had a proprietary right to have it run in their interests. Historically, this was a natural assumption. Shareholders were active in management and had an equitable interest in

[5] A.A. Berle, *For Whom Corporate Managers are Trustees: A Note* (1932) 45 Harv. L. Rev. 1365 at

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the company s assets. However, following incorporation by registration and the separation of ownership and control, this trend ended. Those in control of the company became increasingly detached from those who contributed the capital. The court s increased recognition of corporate personality ensured that the company itself became incapable of being owned.

There is little doubt that today the ownership argument is not a sufficient justification for the shareholder s central position as sole recipients of corporate governance protection. The concept that the company could be owned and that ownership claims could be used to justify the level of company law protection was no longer tenable. Therefore, a new conceptualisation of the company was needed.

This new conceptualisation of the company was examined in Chapter 3. The new economic theory of the firm was not based on ownership of the corporation but rather viewed the corporation as a nexus of contracts. Company law protection was not based on the strength of ownership claims but rather on the ability of the various parties to protect themselves via contract. Traditional legal theorists leapt upon this to justify their shareholder-centred model by stating that the shareholders were unable to protect themselves via contract due to the unilateral nature of the articles of association.

However, like the ownership argument, the new economic theory suffered from several descriptive inaccuracies, notably, to describe statutory provisions as off the shelf contractual terms is sophistical. Further the free bargaining that the new economic theory envisages is not present in many large companies. Finally, the new economic theory took too narrow a view by focusing solely on the agency costs that arise between the directors and the shareholders. Despite this, the new economic theory remains the dominant contemporary conceptualisation of the corporation. However, there are indications that it is waning as an accurate conceptualisation and is starting to be regarded instead as a useful heuristic.

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Both of the above conceptualisations tended to be pro-shareholder. The ownership model focused solely on the ownership claim of the shareholders. The new economic theory focused solely on the shareholder s inability to protect themselves via contract. This inherent bias towards shareholders was revealed in Chapter 4 when we examined the legal protection offered to the various constituents within the company. We saw that traditionally the directors owe their duties to the company. When defining who constitutes the company, it is well established that it is to mean the shareholders. However, when we examined the authority for this, we found it to be highly unconvincing.

As a corollary of this shareholder centred model, the protection offered to non-shareholder constituents is extremely weak. We saw that the directors duties have been modified to take into account the interests of creditors. However, the duty comes into effect at a very late stage, by which time there are unlikely to be any assets left to pay the company s creditors. There is the potential of effective protection in the shape of s.214 Insolvency Act 1986 and the provisions contained in the Company Directors Disqualification Act 1986. However, we saw that the effectiveness of these provisions is emasculated by the funding limitations of the various enforcement authorities.

Employee protection is similarly weak. Again the directors duties were modified to take into account the interests of employees by s.309 Companies Act 1985. However, as we saw, there is no practical way for employees to enforce the duty. In fact, the effect of s.309 may be to actually reduce accountability by increasing the scope of the directors decisionmaking power. The ineffectiveness of s.309 was recognised by the Company Law Review Steering Group who recommended it not be part of the next Companies Act.

Chapter 4 demonstrated that UK company law in heavily influenced by the legal model of the company. This was backed up in Chapter 5 which examined the various corporate governance mechanisms in the UK. Chapter 5 stated that virtually all of the mechanisms existed in order to protect the shareholders, give the shareholders a voice or exert pressures upon the directors to act like shareholders. In other words, corporate governance mechanisms, like the protection offered by our company law, adopt a shareholder-centred approach.

These opening five chapters form Part I of this thesis. Their intention was to examine the theoretical and practical basis behind the UK system of corporate governance. We saw that traditionally conceptualisations of the company have tended to adopt a pro-shareholder ideology. This theoretical basis has heavily influenced practical protection with both UK company law and corporate governance mechanisms adopting a pro-shareholder ideology. Over the last 20 years, this has started to change but not in a satisfactory way. Stakeholder protection is piecemeal and largely ineffective.

The following three chapters form Part II of the thesis. Their aim is to provide a more acceptable theoretical and economic justification for increased stakeholder protection. First, however, the basis of the legal model of the company was examined in Chapter 6. We saw that the legal model has two facets. The first was that the company should act solely in the interests of shareholders. The second was a corollary of the first. As companies should act solely in the interests of shareholders, company law should facilitate this by solely protecting the shareholders.

Regarding the first facet, we examined four theories traditionally use to justify a profit maximising approach. We saw that these theories are no longer capable of justifying such a rigid adherence to profit maximisation.

It was the second facet that was to form the basis of this thesis contention that corporate governance protection should be expanded to include non-shareholder constituents. Here we examined three theories used by legal model theorists to justify exclusive shareholder corporate governance protection, namely the ownership argument, the residual risk argument and the inadequacies of contract argument. In relation to the shareholders, we saw that the first two theories were no longer sufficient to justify exclusive shareholder protection. The inadequacy of contract argument certainly provides a strong justification for shareholder protection because the shareholders cannot protect themselves via contract. However, as we saw in

Chapter 7, it does not provide a sufficient justification for *exclusive* shareholder protection.

Chapter 7 took the traditional justifications for exclusive shareholder governance protection, examined in Part II of Chapter 6, and used them to justify expanding the ambit of shareholder protection to include the company s employees and its creditors. We saw that both the employees and the creditors have an ownership claim akin to that of the shareholders. Like the shareholders, their ownership claim is so weak that it cannot be said that they in any way own the company. The point is that if the shareholders are to receive corporate governance protection based on their ownership claim, then the employees and creditors should also be included.

In Chapter 6, we saw that the shareholders can minimise their risk by a policy of equity diversification. Nevertheless, they still face risk resulting from fluctuations in corporate performance. However, legal model theorists contend that they are the only party to face such risk. In Chapter 7, we saw that this was not the case. We saw that both the employees and the creditors can be adversely affected by changes in the corporation s fortunes. Again, as with the ownership argument, the employees and creditors have a claim akin to that of the shareholders. Accordingly, they should receive comparable protection.

The final justification examined in Chapter 7 related to the ability of the relevant parties to protect themselves via contract. In Chapter 6, we saw that the shareholders cannot protect themselves via contract. However, the legal model theory relies on the assumption that other stakeholder can. As we saw in Chapter 7, this is not the case. The ability of the employees and the creditors to protect themselves via contract is almost as limited as that of the shareholders. Legal model theory argues that fiduciary duties should be owed exclusively to shareholders to fill in the gaps in their contractual protection. If other stakeholders also have such gaps in their protection, then they also have a claim to similar protection.

Many corporate governance theorists concentrate on the issues examined in the previous two chapters, namely should corporations act solely in the interests of shareholders or should they be encouraged to act in a socially responsible manner.

However, what these theorists tend to ignore is the lawfulness of acts that depart from the legal model of the company. We have seen that the legal model is still the predominant influence on our company law and historically, acts that did not benefit the shareholders have been held unlawful; the cases of Parke v Daily News[6] and Dodge v Motor Ford Co.[7] being the most famous examples. Arguments about whether or not corporations should be socially responsible are irrelevant if the law does not permit such responsibility.

The lawfulness of acts that depart from the legal model as the focus of Chapter 8. The ambit of acts that depart from the legal model is extremely wide and so to limit this ambit and provide as comprehensive a lawful picture as possible, I chose to examine the lawfulness of the most extreme form of act that departs from the legal model, namely corporate philanthropy. Basically, we saw that in the UK the position is far from clear. The ambit of the *ultra vires* doctrine is far from clear and is in the process of being abolished. The director s fiduciary duties revolve around acting in the interests of the company. Traditionally, this has come to mean the shareholders. The authority for this is, however, highly unsatisfactory. Accordingly, as a principle it is uncertain. If non-shareholders are to become recipients of company law protection, we need to clarify the law significantly.

Chapter 8 concluded Part II of this thesis. The aim of Part II was to highlight the inadequacies of the legal model of the company — a model which has had a profound effect on UK company law since its creation. We saw that the theories relied upon by legal model theorists are no longer sufficient to justify their shareholder-centred model. In fact, the theories that they propose can now be used to justify a move away from the legal model and a move towards increasing the ambit of corporate governance protection to include non-shareholder constituents.

Part III of this thesis concerned corporate environmental responsibility. Corporate environmental responsibility has not received much attention from corporate academics because companies tend to be regulated by the general environmental law. The various regulatory methods used by general environmental law were examined.

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[6] [1962] Ch. 927.

We saw that no one method is effective in regulating corporate environmental activity. This regulation was made all the more difficult by the unique nature of the corporation which allows it to evade or compensate against the various mechanisms examined. Finally, we took the traditional justifications examined in Chapter 6 and expanded upon in Chapter 7, and used them to justify expanding the protection offered to the environment, just as we did in relation to the employees and the creditors.

The final part of this thesis was Chapter 10 which examined an area of imminent reform that could have an impact upon the main issues brought up in this thesis, namely the work of the Company Law Review Steering Group. Notably, we looked at the statutory statement of directors duties and the Operating and Financial Review. We noted, with optimism, the effect that these reforms could have. However, they are only a first step and the reforms are relatively conservative. It remains to be seen what the final versions will be and how effective they will be in practice.

The issue of in whose interests should the company be run and whose interests should company law protect is the oldest unanswered question in company law. The largest obstacle to increased recognition of non-shareholder constituents is devising a mechanism of accountability that does not fall foul of the too many masters line of criticism. It has not been the aim of this thesis to devise such a mechanism. Before such mechanisms can be created, we need to know why they should be created. An approach that moves away from the legal model needs to be justified. The aim of this thesis has been to demonstrate that the traditional theories behind our company law are increasingly anachronistic and inaccurate. The legal model is increasingly being viewed as too narrow and inefficient in the long term. New theories are emerging in opposition to the legal model, yet using the same lines of reasoning that the legal model once used.

The aim of this thesis has been to demonstrate the increasing validity of these theories. Theories of this kind are still in a relatively embryonic stage when compared to the legal model of the company. However it is my belief that they are starting to

[7] 170 NW 668 (1919).

erode the validity of the legal model. It is a long and ongoing process but ultimately one which will lead to a justification strong enough to convince our corporations and lawmakers to adopt a more stakeholder orientated approach.

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